Internal Revenue Bulletin

Cumulative Bulletin 1964-1 (Part 2)

TREASURY DEPARTMENT · INTERNAL REVENUE SERVICE

FEDERAL TAX LAWS AND COMMITTEE REPORTS

JANUARY-JUNE 1964

Internal Revenue Bulletin

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FINDING LIST

ABBREVIATIONS

The following abbeviations in current use and formerly used will appear in material published in the Bulletin.

A, *B*, *C*, *etc.*—The names of individuals.
A.R.R.—Committee on Appeals and Review recommendation.
A.T.—Alcohol and tobacco tax ruling.
B.T.A.—Board of Tax Appeals.
C.B.—Cumulative Bulletin.
C.F.R.—Code of Federal Regulations.
Ct. D.—Court Decision.
Del. Order—Delegation Order.
D.C.—Treasury Department circular.
E.O.—Executive Order.
E.T.—Estate and gift tax ruling.
Em. T.—Employment tax ruling.
F.A.A.A.—Federal Alcohol Administration Act.
F.R.—Federal Register.
G.C.M.—Chief Counsel's memorandum (formerly General Counsel's memorandum).
I.R.B.—Internal Revenue Bulletin.
IR-Mim.—Published IR-Mimeograph.
I.T.—Income tax ruling.
M, *N*, *X*, *Y*, *Z*, *etc.*—The names of corporations, places or businesses, according to context.
M.T.—Miscellaneous tax ruling.
Mim.—Published mimeograph.
O.D.—Office Decision.
P.L.—Public Law.
P.S.—Pension, profit-sharing, stock bonus or annuity plan ruling.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
R.S.—Revised Statute.
S.M.—Solicitor's Memorandum.
Sol. Op.—Solicitor's Opinion.
S.P.R.—Statement of Procedural Rules.
S.R.—Solicitor's Recommendation.
S.S.T.—Social Security Tax
S.T.—Sales tax ruling.
Stat.—Statutes at Large.
T.C.—The Tax Court of the United States.
T.D.—Treasury Decision.
T.I.R.—Technical Information Release.
U.S.C.—United States Code.
x and *y* used to represent certain numbers and when used with the word "dollars" represent sums of money.

INTRODUCTION

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for the announcement of official rulings and procedures of the Internal Revenue Service, and for the publication of Treasury Decisions, Executive Orders, tax conventions, legislation, and court decisions pertaining to internal revenue matters. Other items considered to be of general interest are also published in the Bulletin, such as announcements relating to proposed regulations published with notice of proposed rulemaking, announcements relating to decisions of the Tax Court of the United States, announcements of the disbarment and suspension of attorneys and agents from practice before the Internal Revenue Service, Delegation Orders, names of organizations whose status as tax-exempt organizations for purposes of section 170 of the Internal Revenue Code of 1954 has been changed, etc.

It is the policy of the Service to publish in the Bulletin all substantive and procedural rulings of importance or of general interest, the publication of which is considered necessary to promote a uniform application of the laws administered by the Service. It is also the policy to publish all rulings and statements of procedures which supersede, revoke, modify, or amend any published ruling or procedure. Except where otherwise indicated, published rulings and procedures apply retroactively. Rulings and statements of procedures relating solely to matters of internal management are not published. However, statements of internal practices and procedures affecting rights or duties of taxpayers, or industry regulation, which appear in internal management documents, are published. Revenue Rulings and Revenue Procedures are based upon rulings and internal management documents prepared in the various divisions of the National Office, including the Office of the Chief Counsel for the Internal Revenue Service. In the preparation of these, caution is exercised to conceal the identity of the taxpayer, as well as any confidential personal and business information.

Revenue Rulings and Revenue Procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose. No unpublished ruling or decision will be cited or relied upon by any officer or employee of the Internal Revenue Service as a precedent in the disposition of other cases.

Since each published ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same. In applying rulings and procedures pub-

lished in the Bulletin, personnel of the Service and others concerned must consider the effect of subsequent legislation, regulations, court decisions, rulings, and procedures.

Each published ruling is designated as a "Revenue Ruling," and each published procedure is designated as a "Revenue Procedure." These should be cited by reference to the year of issuance and the Bulletin and page where reported. Thus, Revenue Ruling No. 1 for 1964 should be cited as "Rev. Rul. 64–1, C.B. 1964–1 (Part 1), 7." Similarly Revenue Procedure No. 1 for 1964 should be cited as "Rev. Proc. 64–1, C.B. 1964–1 (Part 1), 640." Revenue Rulings are keyed to the applicable sections of the Internal Revenue Code and Regulations.

The regulations, rulings, decisions, procedures, etc., published in the weekly Revenue Bulletins 1964–1 through 1964–26 have been consolidated and are published in Internal Revenue Cumulative Bulletin 1964–1 (Part 1).

Cumulative Bulletin 1964–1 (Part 2) is prepared in two parts, as follows:

I. Part I contains the Public Laws pertaining to internal revenue matters enacted by the 88th Congress on or after December 13, 1963.

II. Part II contains Committee and Conference Reports related to the legislation published in Part I. House, Senate, and Conference Committee Reports printed in the Bulletin do not include the portion entitled "Changes in Existing Law."

PART I

TAX LEGISLATION

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PART I

TAX LEGISLATION

PUBLIC LAW 88-203
EIGHTY-EIGHTH CONGRESS, DECEMBER 13, 1963
S. 1703 [1]

An Act to amend title V of the Agricultural Act of 1949, as amended, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That section 510 of the Agricultural Act of 1949, as amended, is amended by striking "December 31, 1963" and inserting "December 31, 1964."

Approved December 13, 1963.

PUBLIC LAW 88-231
EIGHTY-EIGHTH CONGRESS, DECEMBER 23, 1963
H.R. 8527 [2]

An Act to provide for the disposition of the judgment funds on deposit to the credit of the Kootenai Tribe or Band of Indians, Idaho.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the unexpended balance of funds on deposit in the Treasury of the United States to the credit of the Kootenai Tribe or Band of Indians of the State of Idaho that were appropriated by the Act of September 8, 1960 (74 Stat. 830), to pay a judgment by the Indian Claims Commission in docket 154, and the interest thereon, may be advanced or expended for any purpose that is authorized by the tribal governing body and by the Secretary of the Interior. Any part of such funds that may be distributed per capita to the members of the tribe shall not be subject to the Federal or State income tax.

Approved December 23, 1963.

[1] Senate Report No. 372, page 117; since the relevant portions of House Report No. 274 are substantially the same as those contained in the Senate report, the House Report is not published herein.

[2] House Report No. 903 and Senate Report No. 584 are not published herein.

PUBLIC LAW 88-272
EIGHTY-EIGHTH CONGRESS, FEBRUARY 26, 1964
H.R.8363 [1]

An Act to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DECLARATION BY CONGRESS.

It is the sense of Congress that the tax reduction provided by this Act through stimulation of the economy, will, after a brief transitional period, raise (rather than lower) revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. To further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

SEC. 2. SHORT TITLE, ETC.

(a) Short Title.—This Act may be cited as the "Revenue Act of 1964".

(b) Amendment of 1954 Code.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

Title I—Reduction of Income Tax Rates and Related Amendments

PART I—INDIVIDUALS

SEC. 111. REDUCTION OF TAX ON INDIVIDUALS.

(a) Individuals Other Than Heads of Households.—Subsection (a) of section 1 (relating to rates of tax on individuals other than heads of households) is amended to read as follows:

"(a) Rates of Tax on Individuals.—

"(1) Taxable years beginning in 1964.—In the case of a taxable year beginning on or after January 1, 1964, and before January 1, 1965, there is hereby imposed on the taxable income of every individual (other than a head of a household to whom subsection (b) applies) a tax determined in accordance with the following table:

"If the taxable income is:	The tax is:
Not over $500	16% of the taxable income.
Over $500 but not over $1,000	$80, plus 16.5% of excess over $500.
Over $1,000 but not over $1,500	$162.50, plus 17.5% of excess over $1,000.
Over $1,500 but not over $2,000	$250, plus 18% of excess over $1,500.
Over $2,000 but not over $4,000	$340, plus 20% of excess over $2,000.
Over $4,000 but not over $6,000	$740, plus 23.5% of excess over $4,000.
Over $6,000 but not over $8,000	$1,210, plus 27% of excess over $6,000.
Over $8,000 but not over $10,000	$1,750, plus 30.5% of excess over $8,000.
Over $10,000 but not over $12,000	$2,360, plus 34% of excess over $10,000.
Over $12,000 but not over $14,000	$3,040, plus 37.5% of excess over $12,000.
Over $14,000 but not over $16,000	$3,790, plus 41% of excess over $14,000.
Over $16,000 but not over $18,000	$4,610, plus 44.5% of excess over $16,000.

[1] House Reports No. 749 (Committee on Ways and Means), page 125, and No. 1149 (Committee of Conference), page 774, Senate Reports No. 830, page 505, No. 830 Part 2 (Committee on Finance), page 700, and Brief Summary of the Provisions of H.R. 8363, page 830.

"If the taxable income is:	The tax is:
Over $18,000 but not over $20,000	$5,500, plus 47.5% of excess over $18,000.
Over $20,000 but not over $22,000	$6,450, plus 50.5% of excess over $20,000.
Over $22,000 but not over $26,000	$7,460, plus 53.5% of excess over $22,000.
Over $26,000 but not over $32,000	$9,600, plus 56% of excess over $26,000.
Over $32,000 but not over $38,000	$12,960, plus 58.5% of excess over $32,000.
Over $38,000 but not over $44,000	$16,470, plus 61% of excess over $38,000.
Over $44,000 but not over $50,000	$20,130, plus 63.5% of excess over $44,000.
Over $50,000 but not over $60,000	$23,940, plus 66% of excess over $50,000.
Over $60,000 but not over $70,000	$30,540, plus 68.5% of excess over $60,000.
Over $70,000 but not over $80,000	$37,390, plus 71% of excess over $70,000.
Over $80,000 but not over $90,000	$44,490, plus 73.5% of excess over $80,000.
Over $90,000 but not over $100,000	$51,840, plus 75% of excess over $90,000.
Over $100,000 but not over $200,000	$59,340, plus 76.5% of excess over $100,000.
Over $200,000	$135,840, plus 77% of excess over $200,000.

"(2) Taxable years beginning after December 31, 1964.—In the case of a taxable year beginning after December 31, 1964, there is hereby imposed on the taxable income of every individual (other than a head of a household to whom subsection (b) applies) a tax determined in accordance with the following table:

"If the taxable income is:	The tax is:
Not over $500	14% of the taxable income.
Over $500 but not over $1,000	$70, plus 15% of excess over $500.
Over $1,000 but not over $1,500	$145, plus 16% of excess over $1,000.
Over $1,500 but not over $2,000	$225, plus 17% of excess over $1,500.
Over $2,000 but not over $4,000	$310, plus 19% of excess over $2,000.
Over $4,000 but not over $6,000	$690, plus 22% of excess over $4,000.
Over $6,000 but not over $8,000	$1,130, plus 25% of excess over $6,000.
Over $8,000 but not over $10,000	$1,630, plus 28% of excess over $8,000.
Over $10,000 but not over $12,000	$2,190, plus 32% of excess over $10,000.
Over $12,000 but not over $14,000	$2,830, plus 36% of excess over $12,000.
Over $14,000 but not over $16,000	$3,550, plus 39% of excess over $14,000.
Over $16,000 but not over $18,000	$4,330, plus 42% of excess over $16,000.
Over $18,000 but not over $20,000	$5,170, plus 45% of excess over $18,000.
Over $20,000 but not over $22,000	$6,070, plus 48% of excess over $20,000.
Over $22,000 but not over $26,000	$7,030, plus 50% of excess over $22,000.
Over $26,000 bu not over $32,000	$9,030, plus 53% of excess over $26,000.
Over $32,000 but not over $38,000	$12,210, plus 55% of excess over $32,000.
Over $38,000 but not over $44,000	$15,510, plus 58% of excess over $38,000.
Over $44,000 but not over $50,000	$18,990, plus 60% of excess over $44,000.
Over $50,000 but not over $60,000	$22,590, plus 62% of excess over $50,000.
Over $60,000 but not over $70,000	$28,790, plus 64% of excess over $60,000.
Over $70,000 but not over $80,000	$35,190, plus 66% of excess over $70,000.
Over $80,000 but not over $90,000	$41,790, plus 68% of excess over $80,000.
Over $90,000 but not over $100,000	$48,590, plus 69% of excess over $90,000.
Over $100,000	$55,490, plus 70% of excess over $100,000."

(b) HEADS OF HOUSEHOLDS.—Paragraph (1) of section 1(b) (relating to rates of tax on heads or households) is amended to read as follows:

"(1) RATES OF TAX.—

"(A) TAXABLE YEARS BEGINNING IN 1964.—In the case of a taxable year beginning on or after January 1, 1964, and before January 1, 1965, there is hereby imposed on the taxable income of every individual who is the head of a household a tax determined in accordance with the following table:

"If the taxable income is:	The tax is:
Not over $1,000	16% of the taxable income.
Over $1,000 but not over $2,000	$160, plus 17.5% of excess over $1,000.
Over $2,000 but not over $4,000	$335, plus 19% of excess over $2.000.
Over $4,000 but not over $6,000	$715, plus 22% of excess over $4,000.
Over $6,000 but not over $8,000	$1,155, plus 23% of excess over $6,000.
Over $8,000 but not over $10,000	$1,615, plus 27% of excess over $8,000.
Over $10,000 but not over $12,000	$2,155, plus 29% of excess over $10,000.
Over $12,000 but not over $14,000	$2,735, plus 32% of excess over $12,000.
Over $14,000 but not over $16,000	$3,375, plus 34% of excess over $14,000.
Over $16,000 but not over $18,000	$4,055, plus 37.5% of excess over $16,000.
Over $18,000 but not over $20,000	$4,805, plus 39% of excess over $18,000.
Over $20,000 but not over $22,000	$5,585, plus 42.5% of excess over $20,000.
Over $22,000 but not over $24,000	$6,435, plus 43.5% of excess over $22,000.
Over $24,000 but not over $26,000	$7,305, plus 45.5% of excess over $24,000.
Over $26,000 but not over $28,000	$8,215, plus 47% of excess over $26,000.
Over $28,000 but not over $32,000	$9,155, plus 48.5% of excess over $28,000.
Over $32,000 but not over $36,000	$11,095, plus 51.5% of excess over $32,000.
Over $36,000 but not over $38,000	$13,155, plus 53% of excess over $36,000.
Over $38,000 but not over $40,000	$14,215, plus 54% of excess over $38,000.
Over $40,000 but not over $44,000	$15,295, plus 56% of excess over $40,000.
Over $44,000 but not over $50,000	$17,535, plus 58.5% of excess over $44,000.
Over $50,000 but not over $52,000	$21,045, plus 59.5% of excess over $50,000.
Over $52,000 but not over $60,000	$22,235, plus 61% of excess over $52,000.
Over $60,000 but not over $64,000	$27,115, plus 62% of excess over $60,000.
Over $64,000 but not over $70,000	$29,595, plus 63.5% of excess over $64,000.
Over $70,000 but not over $76,000	$33,405, plus 65% of excess over $70,000.
Over $76,000 but not over $80.000	$37,305, plus 66% of excess over $76.000.
Over $80,000 but not over $88,000	$39,945, plus 67% of excess over $80.000.
Over $88,000 but not over $90,000	$45,305, plus 69% of excess over $88,000.
Over $90,000 but not over $100,000	$46,685, plus 69.5% of excess over $90,000.
Over $100,000 but not over $120,000	$53,635, plus 71% of excess over $100,000.
Over $120,000 but not over $140,000	$67,835, plus 72.5% of excess over $120,000.
Over $140,000 but not over $160,000	$82,335, plus 74% of excess over $140,000.
Over $160,000 but not over $180,000	$97,135, plus 75% of excess over $160,000.
Over $180,000 but not over $200,000	$112.135, plus 75.5% of excess over $180,000.
Over $200,000	$127.235, plus 77% of excess over $200,000.

"(B) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1964.—In the case of a taxable year beginning after December 31, 1964, there is hereby imposed on the taxable income of every individual who is the head of a household a tax determined in accordance with the following table:

"If the taxable income is:	The tax is:
Not over $1.000	14% of the taxable income.
Over $1,000 but not over $2,000	$140, plus 16% of excess over $1.000.
Over $2,000 but not over $4,000	$300, plus 18% of excess over $2,000.

Over $4,000 but not over $6,000	$660, plus 20% of excess over $4,000.
Over $6,000 but not over $8,000	$1,060, plus 22% of excess over $6,000.
Over $8,000 but not over $10,000	$1,500, plus 25% of excess over $8,000.
Over $10,000 but not over $12,000	$2,000, plus 27% of excess over $10,000.
Over $12,000 but not over $14,000	$2,540, plus 31% of excess over $12,000.
Over $14,000 but not over $16,000	$3,160, plus 32% of excess over $14,000.
Over $16,000 but not over $18,000	$3,800, plus 35% of excess over $16,000.
Over $18,000 but not over $20,000	$4,500, plus 36% of excess over $18,000.
Over $20,000 but not over $22,000	$5,220, plus 40% of excess over $20,000.
Over $22,000 but not over $24,000	$6,020, plus 41% of excess over $22,000.
Over $24,000 but not over $26,000	$6,840, plus 43% of excess over $24,000.
Over $26,000 but not over $28,000	$7,700, plus 45% of excess over $26,000.
Over $28,000 but not over $32,000	$8,600, plus 46% of excess over $28,000.
Over $32,000 but not over $36,000	$10,440, plus 48% of excess over $32,000.
Over $36,000 but not over $38,000	$12,360, plus 50% of excess over $36,000.
Over $38,000 but not over $40,000	$13,360, plus 52% of excess over $38,000.
Over $40,000 but not over $44,000	$14,400, plus 53% of excess over $40,000.
Over $44,000 but not over $50,000	$16,520, plus 55% of excess over $44,000.
Over $50,000 but not over $52,000	$19,820, plus 56% of excess over $50,000.
Over $52,000 but not over $64,000	$20,940, plus 58% of excess over $52,000.
Over $64,000 but not over $70,000	$27,900, plus 59% of excess over $64,000.
Over $70,000 but not over $76,000	$31,440, plus 61% of excess over $70,000.
Over $76,000 but not over $80,000	$35,100, plus 62% of excess over $76,000.
Over $80,000 but not over $88,000	$37,580, plus 63% of excess over $80,000.
Over $88,000 but not over $100,000	$42,620, plus 64% of excess over $88,000.
Over $100,000 but not over $120,000	$50,300, plus 66% of excess over $100,000.
Over $120,000 but not over $140,000	$63,500, plus 67% of excess over $120,000.
Over $140,000 but not over $160,000	$76,900, plus 68% of excess over $140,000.
Over $160,000 but not over $180,000	$90,500, plus 69% of excess over $160,000.
Over $180,000	$104,300, plus 70% of excess over $180,000."

SEC. 112. MINIMUM STANDARD DEDUCTION.

(a) General Rule.—Section 141 (relating to standard deduction) is amended to read as follows:

"SEC. 141. STANDARD DEDUCTION.

"(a) Standard Deduction.—Except as otherwise provided in this section, the standard deduction referred to in this title is the larger of the 10-percent standard deduction or the minimum standard deduction. The standard deduction shall not exceed $1,000, except that in the case of a separate return by a married individual the standard deduction shall not exceed $500.

"(b) Ten-percent Standard Deduction.—The 10-percent standard deduction is an amount equal to 10 percent of the adjusted gross income.

"(c) Minimum Standard Deduction.—The minimum standard deduction is an amount equal to the sum of—

"(1) $100, multiplied by the number of exemptions allowed for the taxable year as a deduction under section 151, plus

"(2)(A) $200, in the case of a joint return of a husband and wife under section 6013,

"(B) $200, in the case of a return of an individual who is not married, or

"(C) $100, in the case of a separate return by a married individual.

"(d) MARRIED INDIVIDUALS FILING SEPARATE RETURNS.—Notwithstanding subsection (a)—

"(1) The minimum standard deduction shall not apply in the case of a separate return by a married individual if the tax of the other spouse is determined with regard to the 10-percent standard deduction.

"(2) A married individual filing a separate return may, if the minimum standard deduction is less than the 10-percent standard deduction, and if the minimum standard deduction of his spouse is greater than the 10-percent standard deduction of such spouse, elect (under regulations prescribed by the Secretary or his delegate) to have his tax determined with regard to the minimum standard deduction in lieu of being determined with regard to the 10-percent standard deduction."

(b) AMENDMENT OF SECTION 2.—The second sentence of section 2(a) (relating to tax in case of joint return or return of surviving spouse) is amended by striking out "and section 3" and inserting in lieu thereof ", section 3, and section 141".

(c) AMENDMENTS OF SECTION 144.—

(1) The first sentence of section 144(b) (relating to change of election of standard deduction) is amended to read as follows: "Under regulations prescribed by the Secretary or his delegate, a change of election with respect to the standard deduction for any taxable year may be made after the filing of the return for such year."

(2) Section 144 is amended by adding at the end thereof the following new subsection:

"(c) CHANGE OF ELECTION DEFINED.—For purposes of this title, the term 'change of election with respect to the standard deduction' means—

"(1) a change of an election to take (or not to take) the standard deduction;

"(2) a change of an election to pay (or not to pay) the tax under section 3; or

"(3) a change of an election under section 141(d)(2)."

(d) CONFORMING AMENDMENTS.—

(1) Subparagraph (A) of section 6212(c)(2) (relating to cross references) is amended by striking out **"to take"** and inserting in lieu thereof **"with respect to the"**.

(2) Paragraph (3) of section 6504 (relating to cross references) is amended by striking out **"to take"** and inserting in lieu thereof **"with respect to the"**.

SEC. 113. RELATED AMENDMENTS.

(a) RETIREMENT INCOME CREDIT.—Section 37(a) (relating to credit against tax for retirement income) is amended by striking out "an amount equal to the amount received by such individual as retirement income (as defined in subsection (c) and as limited by subsection (d)), multiplied by the rate provided in section 1 for the first $2,000 of taxable income;" and inserting in lieu thereof "an amount equal to 17 percent, in the case of a taxable year beginning in 1964, or 15 percent, in the case of a taxable year beginning after December 31, 1964, of the amount received by such individual as retirement income (as defined in subsection (c) and as limited by subsection (d));".

(b) TAX ON NONRESIDENT ALIEN INDIVIDUALS.—Section 871 (relating to tax on nonresident alien individuals) is amended—

(1) By striking out "is more than $15,400, except that—" in subsection (b) and inserting in lieu thereof "is more than $19,000 in the case of a taxable year beginning in 1964 or more than $21,200 in the case of a taxable year beginning after 1964, except that—".

(2) By striking out the heading to subsection (a) and inserting in lieu thereof the following:

"(a) NO UNITED STATES BUSINESS—30 PERCENT TAX.—".

(3) By striking out the heading to subsection (b) and inserting in lieu thereof the following:

"(b) NO UNITED STATES BUSINESS—REGULAR TAX.—".

SEC. 114. CROSS REFERENCES TO TAX TABLES, ETC.

(1) For optional tax if adjusted gross income is less than $5,000, see section 301 of this Act.

(2) For income tax collected at source, see section 302 of this Act.

PART II—CORPORATIONS

SEC. 121. REDUCTION OF TAX ON CORPORATIONS.

Section 11 (relating to tax on corporations) is amended to read as follows:

"SEC. 11. TAX IMPOSED.

"(a) CORPORATIONS IN GENERAL.—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

"(b) NORMAL TAX.—The normal tax is equal to the following percentage of the taxable income:

"(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

"(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

"(c) SURTAX.—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

"(1) 22 percent, in the case of a taxable year beginning before January 1, 1964,

"(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

"(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

"(d) SURTAX EXEMPTION.—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

"(e) EXCEPTIONS.—Subsection (a) shall not apply to a corporation subject to a tax imposed by—

"(1) section 594 (relating to mutual savings banks conducting life insurance business),

"(2) subchapter L (sec. 801 and following, relating to insurance companies),

"(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts), or

"(4) section 881(a) (relating to foreign corporations not engaged in business in United States)."

SEC. 122. CURRENT TAX PAYMENTS BY CORPORATIONS.

(a) INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY CORPORATIONS.—Section 6154 (relating to installment payments of estimated income tax by corporations) is amended to read as follows:

"SEC. 6154. INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY CORPORATIONS.

"(a) AMOUNT AND TIME FOR PAYMENT OF EACH INSTALLMENT.—The amount of estimate tax (as defined in section 6016(b)) with respect to which a declaration is required under section 6016 shall be paid as follows:

"(1) PAYMENT IN 4 INSTALLMENTS.—If the declaration is filed on or before the 15th day of the 4th month of the taxable year, the estimated tax shall be paid in 4 installments. The amount and time for payment of each installment shall be determined in accordance with the following table:

"If the taxable year begins in—	The following percentages of the estimated tax shall be paid on the 15th day of the—			
	4th month	6th month	9th month	12th month
1964	1	1	25	25
1965	4	4	25	25
1966	9	9	25	25
1967	14	14	25	25
1968	19	19	25	25
1969	22	22	25	25
1970 or any subsequent year	25	25	25	25

"(2) PAYMENT IN 3 INSTALLMENTS.—If the declaration is filed after the 15th day of the 4th month and not after the 15th day of the 6th month of the taxable year, and is not required by section 6074(a) to be filed on or before the 15th day of such 4th month, the estimated tax shall be paid in 3 installments. The amount and time for payment of each installment shall be determined in accordance with the following table:

"If the taxable year begins in—	The following percentages of the estimated tax shall be paid on the 15th day of the—		
	6th month	9th month	12th month
1964	1⅓	25⅓	25⅓
1965	5⅓	26⅓	26⅓
1966	12	28	28
1967	18⅔	29⅔	29⅔
1968	25⅓	31⅓	31⅓
1969	29⅓	32⅓	32⅓
1970 or any subsequent year	33⅓	33⅓	33⅓

"(3) PAYMENT IN 2 INSTALLMENTS.—If the declaration of estimated tax is filed after the 15th day of the 6th month and not after the 15th day of the 9th month of the taxable year, and is not required by section 6074(a) to be filed on or before the 15th day of such 6th month, the estimated tax shall be paid in 2 installments. The amount and time for payment of each installment shall be determined in accordance with the following table:

"If the taxable year begins in—	The following percentages of the estimated tax shall be paid on the 15th day of the—	
	9th month	12th month
1964	26	26
1965	29	29
1966	34	34
1967	39	39
1968	44	44
1969	47	47
1970 or any subsequent year	50	50

"(4) PAYMENT IN 1 INSTALLMENT.—If the declaration of estimated tax is filed after the 15th day of the 9th month of the taxable year, and is not required by section 6074(a) to be filed on or before the 15th day of such 9th month, the estimated tax shall be paid in 1 installment. The amount and time for payment of the installment shall be determined in accordance with the following table:

"If the taxable year begins in—	The following percentages of the estimated tax shall be paid on the 15th day of the 12th month
1964	52
1965	58
1966	68
1967	78
1968	88
1969	94
1970 or any subsequent year	100

"(5) LATE FILING.—If the declaration is filed after the time prescribed in section 6074(a) (determined without regard to any extension of time for filing the declaration under section 6081), paragraphs (2), (3), and (4) of this subsection shall not apply, and there shall be paid at the time of such filing all installments of estimated tax which would have been payable on or before such time if the declaration had been filed within the time prescribed in section 6074(a), and the remaining installments shall be paid at the times at which, and in the amounts in which, they would have been payable if the declaration had been so filed.

"(b) AMENDMENT OF DECLARATION.—If any amendment of a declaration is filed, the amount of each remaining installment (if any) shall be the amount which would have been payable if the new estimate had been made when the first estimate for the taxable year was made, increased or decreased (as the case may be), by the amount computed by dividing—

"(1) the difference between (A) the amount of estimated tax required to be paid before the date on which the amendment is made, and (B) the amount of estimated tax which would have been required to be paid before such date if the new estimate had been made when the first estimate was made, by

"(2) the number of installments remaining to be paid on or after the date on which the amendment is made.

"(c) APPLICATION TO SHORT TAXABLE YEAR.—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

"(d) INSTALLMENTS PAID IN ADVANCE.—At the election of the corporation, any installment of the estimated tax may be paid before the date prescribed for its payment."

(b) TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.—Section 6074 (relating to time for filing declarations of estimated income tax by corporations) is amended to read as follows:

"SEC. 6074. TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS.

"(a) GENERAL RULE.—The declaration of estimated tax required of corporations by section 6016 shall be filed as follows:

"If the requirements of section 6016 are first met—	The declaration shall be filed on or before—
before the 1st day of the 4th month of the taxable year.	the 15th day of the 4th month of the taxable year.
after the last day of the 3d month and before the 1st day of the 6th month of the taxable year.	the 15th day of the 6th month of the taxable year.
after the last day of the 5th month and before the 1st day of the 9th month of the taxable year.	the 15th day of the 9th month of the taxable year.
after the last day of the 8th month and before the 1st day of the 12th month of the taxable year.	the 15th day of the 12th month of the taxable year.

"(b) AMENDMENT.—An amendment of a declaration may be filed in any interval between installment dates prescribed for the taxable year, but only one amendment may be filed in each such interval.

"(c) SHORT TAXABLE YEAR.—The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate."

(c) FAILURE BY CORPORATIONS TO PAY ESTIMATED INCOME TAX.—

(1) The last sentence of section 6655(c)(2) (relating to period of underpayment) is amended to read as follows: "For purposes of this paragraph, a payment of estimated tax on any installment date shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b)(1) for such installment date."

(2) Paragraph (3) of section 6655(d) (relating to exception) is amended to read as follows:

"(3) (A) An amount equal to 70 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income:

"(i) for the first 3 months of the taxable year, in the case of the installment required to be paid in the 4th month,

"(ii) for the first 3 months or for the first 5 months of the taxable year, in the case of the installment required to be paid in the 6th month,

"(iii) for the first 6 months or for the first 8 months of the taxable year in the case of the installment required to be paid in the 9th month, and

"(iv) for the first 9 months or for the first 11 months of the taxable year, in the case of the installment required to be paid in the 12th month of the taxable year.

"(B) For purposes of this paragraph, the taxable income shall be placed on an annualized basis by—

"(i) multiplying by 12 the taxable income referred to in subparagraph (A), and

"(ii) dividing the resulting amount by the number of months in the taxable year (3, 5, 6, 8, 9, or 11, as the case may be) referred to in subparagraph (A)."

(d) Technical Amendment.—Section 6016(f) (relating to declarations of estimated income tax by corporations) is amended to read as follows:

"(f) Cross Reference.—

"For provisions relating to the number of amendments which may be filed, see section 6074(b)."

SEC. 123. RELATED AMENDMENTS.

(a) Tax on Mutual Insurance Companies (Other Than Life, Etc.)—

(1) Subsection (a) of section 821 (relating to imposition of tax) is amended to read as follows:

"(a) Imposition of Tax.—A tax is hereby imposed for each taxable year beginning after December 31, 1963, on the mutual insurance company taxable income of every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831). Such tax shall consist of—

"(1) Normal tax.—A normal tax of 22 percent of the mutual insurance company taxable income, or 44 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; plus

"(2) Surtax.—A surtax on the mutual insurance company taxable income computed as provided in section 11(c) as though the mutual insurance company taxable income were the taxable income refered to in section 11(c)."

(2) Paragraph (1) of section 821(c) (relating to alternative tax for certain small companies) is amended to read as follows:

"(1) Imposition of tax.—In the case of taxable years beginning after December 31, 1963, there is hereby imposed for each taxable year on the income of each mutual insurance company to which this subsection applies a tax (which shall be in lieu of the tax imposed by subsection (a)) computed as follows:

"(A) Normal Tax.—A normal tax of 22 percent of the taxable investment income, or 44 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; plus

"(B) Surtax.—A surtax on the taxable investment income computed as provided in section 11(c) as though the taxable investment income were the taxable income refered to in section 11(c)."

(b) Receipt of Minimum Distributions by Domestic Corporations.—Subsection (b) of section 963 (relating to receipt of minimum distributions by domestic corporations) is amended to read as follows:

"(b) Minimum Distribution.—For purposes of this section, a minimum distribution with respect to the earnings and profits for the taxable year of any controlled foreign corporation or corporations shall, in the case of any United States shareholder, be its pro rata share of an amount determined in accordance with whichever of the following tables applies to the taxable year:

"(1) TAXABLE YEARS BEGINNING IN 1963.—

"If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 10	90
10 or over but less than 20	86
20 or over but less than 28	82
28 or over but less than 34	75
34 or over but less than 39	68
39 or over but less than 42	55
42 or over but less than 44	40
44 or over but less than 46	27
46 or over but less than 47	14
47 or over	0

"(2) TAXABLE YEARS BEGINNING IN 1964.—

"If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 10	87
10 or over but less than 19	83
19 or over but less than 27	79
27 or over but less than 33	72
33 or over but less than 37	65
37 or over but less than 40	53
40 or over but less than 42	38
42 or over but less than 44	26
44 or over but less than 45	13
45 or over	0

"(3) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1964.—

"If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 9	83
9 or over but less than 18	79
18 or over but less than 26	76
26 or over but less than 32	69
32 or over but less than 36	63
36 or over but less than 39	51
39 or over but less than 41	37
41 or over but less than 42	25
42 or over but less than 43	13
43 or over	0"

(c) AMENDMENT OF SECTION 242.—Section 242(a) (relating to deduction for partially tax-exempt interest) is amended by adding at the end thereof the following new sentence: "No deduction shall be allowed under this section for purposes of any surtax imposed by this subtitle."

PART III—EFFECTIVE DATES

SEC. 131. GENERAL RULE.

Except for purposes of section 21 of the Internal Revenue Code of 1954 (relating to effect of changes in rates during a taxable year), the amendments made by parts I and II of this title shall apply with respect to taxable years beginning after December 31, 1963.

SEC. 132. FISCAL YEAR TAXPAYERS.

Effective with respect to taxable years ending after December 31, 1963, subsection (d) of section 21 (relating to effect of changes in rates during a taxable year) is amended to read as follows:

"(d) CHANGES MADE BY REVENUE ACT OF 1964.—

"(1) INDIVIDUALS.—In applying subsection (a) to the taxable year of an individual beginning in 1963 and ending in 1964—

"(A) the rate of tax for the period on and after January 1, 1964, shall be applied to the taxable income determined as if part IV of subchapter B (relating to standard deduction for individuals), as amended

by the Revenue Act of 1964, applied to taxable years ending after December 31, 1963, and

"(B) section 4 (relating to rules for optional tax), as amended by such Act, shall be applied to taxable years ending after December 31, 1963.

In applying subsection (a) to a taxable year of an individual beginning in 1963 and ending in 1964, or beginning in 1964 and ending in 1965, the change in the tax imposed under section 3 shall be treated as a change in a rate of tax.

"(2) CORPORATION.—In applying subsection (a) to a taxable year of a corporation beginning in 1963 and ending in 1964, if—

"(A) the surtax exemption of such corporation for such taxable year is less than $25,000 by reason of the application of section 1561 (relating to surtax exemptions in case of certain controlled corporations), or

"(B) an additional tax is imposed on the taxable income of such corporation for such taxable year by section 1562(b) (relating to additional tax in case of component members of controlled groups which elect multiple surtax exemptions),

the change in the surtax exemption, or the imposition of such additional tax, shall be treated as a change in a rate of tax taking effect on January 1, 1964."

Title II—Structural Changes

SEC. 201. DIVIDENDS RECEIVED BY INDIVIDUALS.

(a) REDUCTION OF 4 PERCENT CREDIT TO 2 PERCENT CREDIT FOR CALENDAR YEAR 1964.—

(1) GENERAL RULE.—Section 34(a) (relating to general rule for credit for dividends received) is amended by striking out "an amount equal to 4 percent of the dividends which are received after July 31, 1954, from domestic corporations and are included in gross income" and inserting in lieu thereof:

"an amount equal to the following percentage of the dividends which are received from domestic corporations and are included in gross income:

"(1) 4 percent of the amount of such dividends which are received before January 1, 1964, and

"(2) 2 percent of the amount of such dividends which are received during the calendar year 1964."

(2) LIMITATIONS.—Section 34(b)(2) (relating to limitations on amount of credit) is amended—

(A) by inserting ", or beginning after December 31, 1963" after "1955" at the end of subparagraph (A), and

(B) by inserting ", and beginning before January 1, 1964" after "1954" at the end of subparagraph (B).

(b) REPEAL OF CREDIT FOR DIVIDENDS RECEIVED BY INDIVIDUALS.—Effective with respect to dividends received after December 31, 1964, section 34 (relating to dividends received by individuals) is hereby repealed.

(c) DOUBLING OF AMOUNT OF PARTIAL EXCLUSION FROM GROSS INCOME OF DIVIDENDS RECEIVED BY INDIVIDUALS.—Section 116(a) (relating to partial exclusion from gross income of dividends received by individuals) is amended by striking out "$50" each place it appears and inserting in lieu thereof "$100".

(d) CONFORMING AMENDMENTS.—

(1) The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by striking out

"Sec. 34. Dividends received by individuals."

(2) Section 35(b)(1) is amended by striking out "the sum of the credits allowable under sections 33 and 34" and inserting in lieu thereof "the credit allowable under section 33".

(3) Section 37(a) is amended by striking out "section 34 (relating to credit for dividends received by individuals).".

(4) Section 46(a)(3) is amended by striking out subparagraph (B), and by redesignating subparagraphs (C) and (D) as "(B)" and "C", respectively.

(5) Section 584(c)(2) is amended by striking out "section 34 or".

(6) (A) Section 642(a) is amended by striking out paragraph (3);

(B) Section 642(i) is amended to read as follows:

"(i) CROSS REFERENCES.—

"(1) For disallowance of standard deduction in case of estates and trusts, see section 142(b)(4).

"(2) For special rule for determining the time of receipt of dividends by a beneficiary under section 652 or 662, see section 116(c)(3)."

(C) Section 116(c) is amended by adding at the end thereof the following new paragraph:

"(3) The amount of dividends properly allocable to a beneficiary under section 652 or 662 shall be deemed to have been received by the beneficiary ratably on the same date that the dividends were received by the estate or trust."

(7) Section 702(a)(5) is amended by striking out "a credit under section 34," and the comma after "section 116".

(8) Section 854(a) is amended by striking out "section 34(a) (relating to credit for dividends received by individuals)," and the comma after "section 116 (relating to an exclusion for dividends received by individuals)".

(9) Secton 854(b)(1) is amended by striking out "the credit under section 34(a)," and the comma after "section 116".

(10) Section 854(b)(2) is amended by striking out "the credit under section 34," and the comma after "section 116".

(11) Section 857(c) is amended by striking out "section 34(a) (relating to credit for dividends received by individuals)," and the comma after "section 116 (relating to an exclusion for dividends received by individuals)".

(12) Secton 871(b) is amended by striking out "the sum of the credits under sections 34 and 35" and inserting in lieu thereof "the credit under section 35".

(13) Section 1375(b) is amended by striking out "section 34," and the comma after "section 37".

(14) Section 6014(a) is amended by striking out "34 or".

(e) EFFECTIVE DATES.—The amendments made by subsection (a) shall apply with respect to taxable years ending after December 31, 1963. The amendment made by subsection (b) shall apply with respect to taxable years ending after December 31, 1964. The amendment made by subsection (c) shall apply with respect to taxable years beginning after December 31, 1963. The amendments made by subsection (d) shall apply with respect to dividends received after December 31, 1964, in taxable years ending after such date.

SEC. 202. RETIREMENT INCOME CREDIT OF CERTAIN MARRIED INDIVIDUALS.

(a) DETERMINATION OF RETIREMENT INCOME.—Section 37 (relating to retirement income) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) SPECIAL RULES FOR CERTAIN MARRIED COUPLES.—

"(1) ELECTION.—A husband and wife who make a joint return for the taxable year and both of whom have attained the age of 65 before the close of the taxable year may elect (at such time and in such manner as the Secretary or his delegate by regulations prescribes) to determine the amount of the credit allowed by subsection (a) by applying the provisions of paragraph (2).

"(2) SPECIAL RULES.—If an election is made under paragraph (1) for the taxable year, for purposes of subsection (a)—

"(A) if either spouse is an individual who has received earned income within the meaning of subsection (b), the other spouse shall be considered to be an individual who has received earned income within the meaning of such subsection; and

"(B) subsection (d) shall be considered as providing that the amount of the combined retirement income of both spouses shall not exceed $2.286, less the sum of the amounts specified in paragraphs (1) and (2) of subsection (d) for each spouse."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1963.

SEC. 203. REPEAL OF REQUIREMENT THAT BASIS OF SECTION 38 PROPERTY BE REDUCED BY 7 PERCENT; OTHER PROVISIONS RELATING TO INVESTMENT CREDIT.

(a) Repeal of Requirement That Basis Be Reduced.—

(1) In general.—Subsection (g) of section 48 (requiring that the basis of section 38 property be reduced by 7 percent of the qualified investment) is hereby repealed.

(2) Increase in basis of property placed in service before January 1, 1964.—

(A) The basis of any section 38 property (as defined in section 48(a) of the Internal Revenue Code of 1954) placed in service before January 1, 1964, shall be increased, under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property under section 46(c) of the Internal Revenue Code of 1954. If there has been any increase with respect to such property under section 48(g)(2) of such Code, the increase under the preceding sentence shall be appropriately reduced therefor.

(B) If a lessor made the election provided by section 48(d) of the Internal Revenue Code of 1954 with respect to property placed in service before January 1, 1964—

(i) subparagraph (A) shall not apply with respect to such property, but

(ii) under regulations prescribed by the Secretary of the Treasury or his delegate, the deductions otherwise allowable under section 162 of such Code to the lessee for amounts paid to the lessor under the lease (or, if such lessee has purchased such property, the basis of such property) shall be adjusted in a manner consistent with subparagraph (A).

(C) The adjustments under this paragraph shall be made as of the first day of the taxpayer's first taxable year which begins after December 31, 1963.

(3) Conforming amendments.—

(A) The last sentence of section 48(d) relating to certain leased property) is hereby repealed.

(B) Section 181 (relating to deduction for certain unused investment credit) is hereby repealed.

(C) Section 1016(a)(19) (relating to adjustments to basis) is amended to read as follows:

"(19) to the extent provided in section 48(g) and in section 203(a)(2) of the Revenue Act of 1964, in the case of property which is or has been section 38 property (as defined in section 48(a));"

(D) The table of sections for part VI of subchapter B of chapter 1 is amended by striking out the following:

"Section 181. Deduction for certain unused investment credit."

(4) Effective date.—Paragraphs (1) and (3) of this subsection shall apply—

(A) In the case of property placed in service after December 31, 1963, with respect to taxable years ending after such date, and

(B) in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963.

(b) Basis of Certain Leased Property to Lessee.—Paragraphs (1) and (2) of section 48(d) (relating to certain leased property) are amended to read as follows:

"(1) except as provided in paragraph (2), the fair market value of such property, or

"(2) if such property is leased by a corporation which is a member of an affiliated group (within the meaning of section 46(a)(5)) to another corporation which is a member of the same affiliated group, the basis of such property to the lessor."

(c) Treatment of Elevators and Escalators for Purposes of the Investment Credit.—Section 48(a)(1) (relating to section 38 property) is amended—

(1) by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or"; and

(2) by adding after subparagraph (B) the following new subparagraph:

"(C) elevators and escalators, but only if—

"(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

"(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date."

(d) Tteatment of Elevators and Escalators for Purposes of Section 1245.—Section 1245(a) (relating to gain from dispositions of certain depreciable property) is amended—

(1) by striking out so much of paragraph (2) as precedes the second sentence thereof and inserting in lieu thereof the following:

"(2) Recomputed basis.—For purposes of this section, the term 'recomputed basis' means—

"(A) with respect to any property referred to in paragraph (3) (A) or (B), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961, or

"(B) with respect to any property referred to in paragraph (3)(C), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after June 30, 1963,

reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168.";

(2) by striking out the period at the end of paragraph (3)(B) and inserting in lieu thereof ", or"; and

(3) by additing at the end of paragraph (3) the following new subparagraph:

"(C) an elevator or an escalator."

(e) Treatment of Investment Credit by Federal Regulatory Agencies.—It was the intent of the Congress in providing an investment credit under section 38 of the Internal Revenue Code of 1954, and it is the intent of the Congress in repealing the reduction in basis required by section 48(g) of such Code, to provide an incentive for modernization and growth of private industry (including that portion thereof which is regulated). Accordingly, Congress does not intend that any agency or instrumentality of the United States having jurisdiction with respect to a taxpayer shall, without the consent of the taxpayer, use—

(1) in the case of public utility property (as defined in section 46(c)(3)(B) of the Internal Revenue Code of 1954), more than a proportionate part (determined with reference to the average useful life of the property with respect to which the credit was allowed) of the credit against tax allowed for any taxable year by section 38 of such Code, or

(2) in the case of any other property, any credit against tax allowed by section 38 of such Code,

to reduce such taxpayer's Federal income taxes for the purpose of establishing the cost of service of the taxpayer or to accomplish a similar result by any other method.

(f) Effective Dates.—

(1) The amendments made by subsection (b) shall apply with respect to property possession of which is transferred to a lessee on or after the date of enactment of this Act.

(2) The amendments made by subsection (c) shall apply with respect to taxable years ending after June 30, 1963.

(3) The amendments made by subsection (d) shall apply with respect to dispositions after December 31, 1963, in taxable years ending after such date.

SEC 204. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES.

(a) Inclusion in Income.—

(1) Part II of subchapter B of chapter 1 (relating to items specifically included in gross income) is amended by adding at the end thereof the following new section:

"SEC. 79. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES.

"(a) General Rule.—There shall be included in the gross income of an employee for the taxable year an amount equal to the cost of group-term life

insurance on his life provided for part or all of such year under a policy (or policies) carried directly or indirectly by his employer (or employers); but only to the extent that such cost exceeds the sum of—

"(1) the cost of $50,000 of such insurance, and

"(2) the amount (if any) paid by the employee toward the purchase of such insurance.

"(b) Exceptions.—Subsection (a) shall not apply to—

"(1) the cost of group-term life insurance on the life of an individual which is provided under a policy carried directly or indirectly by an employer after such individual has terminated his employment with such employer and either has reached the retirement age with respect to such employer or is disabled (within the meaning of paragraph (3) of section 213(g), determined without regard to paragraph (4) thereof),

"(2) the cost of any portion of the group-term life insurance on the life of an employee provided during part or all of the taxable year of the employee under which—

"(A) the employer is directly or indirectly the beneficiary, or

"(B) a person described in section 170(c) is the sole beneficiary,

for the entire period during such taxable year for which the employee receives such insurance, and

"(3) the cost of any group-term life insurance which is provided under a contract to which section 72(m)(3) applies.

"(c) Determination of Cost of Insurance.—For purposes of this section and section 6052, the cost of group-term insurance on the life of an employee provided during any period shall be determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by regulations by the Secretary or his delegate. In the case of an employee who has attained age 64, the cost prescribed shall not exceed the cost with respect to such individual if he were age 63."

(2) The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following:

"Sec. 79. Group-term life insurance purchased for employees."

(3) Section 7701(a)(20) (defining employee) is amended by striking out "For the purpose of applying the provisions of sections 104" and inserting in lieu thereof "For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104".

(b) Withholding.—Section 3401(a) (relating to definition of wages) is amended by striking out the period at the end of paragraph (13) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(14) in the form of group-term life insurance on the life of an employee; or".

(c) Information Reporting.—

(1) Requirement.—Subpart C of part III of subchapter A of chapter 61 (relating to information and returns) is amended by adding at the end thereof the following new section:

"SEC. 6052. RETURNS REGARDING PAYMENT OF WAGES IN THE FORM OF GROUP-TERM LIFE INSURANCE.

"(a) Requirement of Reporting.—Every employer who during any calendar year provides group-term life insurance on the life of an employee during part or all of such calendar year under a policy (or policies) carried directly or indirectly by such employer shall make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the cost of such insurance and the name and address of the employee on whose life such insurance is provided, but only to the extent that the cost of such insurance is includible in the employee's gross income under section 79(a). For purposes of this section, the extent to which the cost of group-term life insurance is includible in the employee's gross income under section 79(a) shall be determined as if the employer were the only employer paying such employee remuneration in the form of such insurance.

"(b) Statements To Be Furnished to Employees With Respect to Whom Information Is Furnished.—Every employer making a return under subsection (a) shall furnish to each employee whose name is set forth in such return a

written statement showing the cost of the group-term life insurance shown on such return. The written statement required under the preceding sentence shall be furnished to the employee on or before January 31 of the year following the calendar year for which the return under subsection (a) was made."

(2) Penalties for failure to furnish statements to persons with respect to whom returns are filed.—Section 6678 (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6049(c)" and inserting in lieu thereof "6049(c), or 6052(b)"; and

(B) by striking out "or 6049(a)(1)," and inserting in lieu thereof "6049(a)(1), or 6052(a),".

(3) Clerical amendment.—The table of sections for subpart C of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following:

"Sec. 6052. Returns regarding payment of wages in the form of group-term life insurance."

(4) Cross reference.—For penalty for failure to file information returns required by section 6052(a) of the Internal Revenue Code of 1954 (added by paragraph (1) of this subsection), see section 6652(a)(3) of such Code (as amended by section 221(b)(2) of this Act).

(d) Effective Dates.—The amendments made by subsections (a) and (c), and paragraph (3) of section 6652(a) of the Internal Revenue Code of 1954 (as amended by section 221(b)(2) of this Act), shall apply with respect to group-term life insurance provided after December 31, 1963, in taxable years ending after such date. The amendments made by subsection (b) shall apply with respect to remuneration paid after December 31, 1963, in the form of group-term life insurance provided after such date. In applying section 79(b) of the Internal Revenue Code of 1954 (as added by subsection (a)(1) of this section) to a taxable year beginning before May 1, 1964, if paragraph (2)(B) of such section applies with respect to an employee for the period beginning May 1, 1964, and ending with the close of his first taxable year ending after April 30, 1964, such paragraph (2)(B) shall be treated as applying with respect to such employee for the period beginning January 1, 1964, and ending April 30, 1964.

SEC. 205. AMOUNTS RECEIVED UNDER WAGE CONTINUATION PLANS.

(a) Wage Continuation Plans.—The second sentence of section 105(d) (relating to wage continuation plans) is amended to read as follows: "The preceding sentence shall not apply to amounts attributable to the first 30 calendar days in such period, if such amounts are at a rate which exceeds 75 percent of the regular weekly rate of wages of the employee (as determined under regulations prescribed by the Secretary or his delegate). If amounts attributable to the first 30 calendar days in such period are at a rate which does not exceed 75 percent of the regular weekly rate of wages of the employee, the first sentence of this subsection (1) shall not apply to the extent that such amounts exceed a weekly rate of $75, and (2) shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of personal injuries or sickness for at least one day during such period."

(b) Effective Date.—The amendment made by subsection (a) shall apply to amounts attributable to periods of absence commencing after December 31, 1963.

SEC. 206. EXCLUSION FROM GROSS INCOME OF GAIN ON SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65.

(a) In General.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 121 as section 122 and by inserting before such section the following new section:

"SEC. 121. GAIN FROM SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65.

"(a) General Rule.—At the election of the taxpayer, gross income does not include gain from the sale or exchange of property if—

"(1) the taxpayer has attained the age of 65 before the date of such sale or exchange, and

"(2) during the 8-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as his principal residence for periods aggregating 5 years or more.

"(b) Limitations.—

"(1) Where adjusted sales price exceeds $20,000.—If the adjusted sales price of the property sold or exchanged exceeds $20,000, subsection (a) shall apply to that portion of the gain which bears the same ratio to the total amount of such gain as $20,000 bears to such adjusted sales price. For purposes of the preceding sentence, the term 'adjusted sales price' has the meaning assigned to such term by section 1034(b) (1) (determined with out regard to subsection (d) (7) of this section).

"(2) Application to only one sale or exchange.—Subsection (a) shall not apply to any sale or exchange by the taxpayer if an election by the taxpayer or his spouse under subsection (a) with respect to any other sale or exchange is in effect.

"(c) Election.—An election under subsection (a) may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of the tax imposed by this chapter for the taxable year in which the sale or exchange occurred, and shall be made or revoked in such manner as the Secretary or his delegate shall by regulations prescribe. In the case of a taxpayer who is married, an election under subsection (a) or a revocation thereof may be made only if his spouse joins in such election or revocation.

"(d) Special Rules.—

"(1) Property held jointly by husband and wife.—For purposes of this section, if—

"(A) property is held by a husband and wife as joint tenants, tenants by the entirety, or community property,

"(B) such husband and wife make a joint return under section 6013 for the taxable year of the sale or exchange, and

"(C) one spouse satisfies the age, holding, and use requirements of subsection (a) with respect to such property,

then both husband and wife shall be treated as satisfying the age, holding, and use requirements of subsection (a) with respect to such property.

"(2) Property of deceased spouse.—For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, if—

"(A) the deceased spouse (during the 8-year period ending on the date of the sale or exchange) satisfied the holding and use requirements of subsection (a) (2) with respect to such property, and

"(B) no election by the deceased spouse under subsection (a) is in effect with respect to a prior sale or exchange,

then such individual shall be treated as satisfying the holding and use requirements of subsection (a) (2) with respect to such property.

"(3) Tenant-stockholder in cooperative housing corporation.—For purposes of this section, if the taxpayer holds stock as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as defined in such section), then—

"(A) the holding requirements of subsection (a) (2) shall be applied to the holding of such stock, and

"(B) the use requirements of subsection (a) (2) shall be applied to the house or apartment which the taxpayer was entitled to occupy as such stockholder.

"(4) Involuntary conversions.—For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

"(5) Property used in part as principle residence.—In the case of property only a portion of which, during the 8-year period ending on the date of the sale or exchange, has been owned and used by the taxpayer as his principal residence for periods aggregating 5 years or more, this section shall apply with respect to so much of the gain from the sale or exchange of such property as is determined, under regulations prescribed by the Secretary or his delegate, to be attributable to the portion of the property so owned and used by the taxpayer.

"(6) Determination of marital status.—In the case of any sale or exchange, for purposes of this section—

"(A) the determination of whether an individual is married shall be made as of the date of the sale or exchange; and

"(B) an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

"(7) APPLICATION OF SECTIONS 1033 AND 1034.—In applying sections 1033 (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence), the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to an election under this section."

(b) TECHNICAL AND CLERICAL AMENDMENTS.—

(1) Section 6012(c) (relating to persons required to make returns of income) is amended to read as follows:

(c) CERTAIN INCOME EARNED ABROAD OR FROM SALE OF RESIDENCE.—For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 121 (relating to sale of residence by individual who has attained age 65) and without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States)."

(2) The table of sections for part III of subchapter B of chapter 1 is amended by striking out

"Sec. 121. Cross references to other Acts."

and inserting in lieu thereof

"Sec 121. Gain from sale or exchange of residence of individual who has attained age 65.

"Sec 122. Cross references to other Acts."

(3) Section 1033(h) (relating to involuntary conversions) is amended by adding at the end thereof the following new paragraph:

"(3) For exclusion from gross income of certain gain from involuntary conversion of residence of taxpayer who has attained age 65, see section 121."

(4) Section 1034 (relating to sale or exchange of residence) is amended by adding at the end thereof the following new subsection:

"(k) CROSS REFERENCE.—"For exclusion from gross income of certain gain from sale or exchange of residence of taxpayer who has attained age 65, see section 121."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to dispositions after December 31, 1963, in taxable years ending after such date.

SEC. 207. DENIAL OF DEDUCTION FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES.

(a) IN GENERAL.—Subsections (a), (b), and (c) of section 164 (relating to deduction for taxes) are amended to read as follows:

"(a) GENERAL RULE.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

"(1) State and local, and foreign. real property taxes.

"(2) State and local personal property taxes.

"(3) State and local, and foreign, income, war profits, and excess profits taxes.

"(4) State and local general sales taxes.

"(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).

"(b) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PERSONAL PROPERTY TAXES.—The term 'personal property tax' means an ad valorem tax which is imposed on an annual basis in respect of personal property.

"(2) GENERAL SALES TAXES.—

"(A) IN GENERAL.—The term 'general sales tax' means a tax imposed at one rate in respect of the sale at retail of a broad range of classes of items.

"(B) SPECIAL RULES FOR FOOD, ETC.—In the case of items of food, clothing, medical supplies, and motor vehicles—

"(i) the fact that the tax does not apply in respect of some or all of such items shall not be taken into account in determining

whether the tax applies in respect of a broad range of classes of items, and

"(ii) the fact that the rate of tax applicable in respect of some or all of such items is lower than the general rate of tax shall not be taken into account in determining whether the tax is imposed at one rate.

"(C) ITEMS TAXED AT DIFFERENT RATES.—Except in the case of a lower rate of tax applicable in respect of an item described in subparagraph (B), no deduction shall be allowed under this section for any general sales tax imposed in respect of an item at a rate other than the general rate of tax.

"(D) COMPENSATING USE TAXES.—A compensating use tax in respect of an item shall be treated as a general sales tax. For purposes of the preceding sentence, the term 'compensating use tax' means, in respect of any item, a tax which—

"(i) is imposed on the use, storage, or consumption of such item, and

"(ii) is complementary to a general sales tax, but only if a deduction is allowable under subsection (a)(4) in respect of items sold at retail in the taxing jurisdiction which are similar to such item.

"(3) STATE OR LOCAL TAXES.—A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

"(4) FOREIGN TAXES.—A foreign tax includes only a tax imposed by the authority of a foreign country.

"(5) SEPARATELY STATED GENERAL SALES TAXES AND GASOLINE TAXES.—If the amount of any general sales tax or of any tax on the sale of gasoline, diesel fuel, or other motor fuel is separately stated, then, to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount shall be treated as a tax imposed on, and paid by, such consumer.

"(c) DEDUCTION DENIED IN CASE OF CERTAIN TAXES.—No deduction shall be allowed for the following taxes:

"(1) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

"(2) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer."

(b) TECHNICAL AMENDMENTS.—

(1) The first sentence of section 164(f) (relating to payments for municipal services in atomic energy communities) is amended by inserting "State" before "real property taxes".

(2) Section 164(g) (relating to cross references) is amended to read as follows:

"(g) CROSS REFERENCES.—

"(1) For provisions disallowing any deduction for the payment of the tax imposed by subchapter B of chapter 3 (relating to tax-free covenant bonds), see section 1451.

"(2) For provisions disallowing any deduction for certain taxes, see section 275."

(3)(A) Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding at the end thereof the following new section:

"SEC. 275. CERTAIN TAXES.

"(a) GENERAL RULE.—No deduction shall be allowed for the following taxes:

"(1) Federal income taxes, including—

"(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

"(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

"(C) the tax withheld at source on wages under section 3402, and corresponding provisions of prior revenue laws.

"(2) Federal war profits and excess profits taxes.

"(3) Estate, inheritance, legacy, succession, and gift taxes.

"(4) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

"(5) Taxes on real property, to the extent that section 164(d) requires such taxes to be treated as imposed on another taxpayer.

"(b) Cross Reference.—For disallowance of certain other taxes, see section 164(c)."

(B) The table of sections for such part IX is amended by adding at the end thereof the following:

"Sec. 275. Certain taxes."

(4) Paragraph (1) of section 535(b) (relating to adjustments to accumulated taxable income) is amended by striking out "section 164(b)(6)" and inserting in lieu thereof "section 275(a)(4)".

(5) The first sentence of paragraph (1) of section 545(b) (relating to adjustments to personal holding company taxable income) is amended by striking out "section 164(b)(6)" and inserting in lieu thereof "section 275(a)(4)".

(6) The first sentence of paragraph (1) of section 556(b) (relating to adjustments to foreign personal holding company taxable income) is amended by striking out "section 164(b)(6)" and inserting in lieu thereof "section 275(a)(4)".

(7) Paragraph (1) of section 901(d) (relating to credit for taxes imposed by foreign countries) is amended by striking out "section 164" and inserting in lieu thereof "sections 164 and 275".

(8) Section 903 (relating to credit for taxes imposed by a foreign country in lieu of income, etc., taxes) is amended by striking out "section 164(b)" and inserting in lieu thereof "sections 164(a) and 275(a)".

(c) Effective Date.—

(1) General rule.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1963.

(2) Special taxing districts.—Section 164(c)(1) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall not prevent the deduction under section 164 of such Code (as so amended) of taxes levied by a special taxing district which is described in section 164(b)(5) of such Code (as in effect for a taxable year ending on December 31, 1963) and which was in existence on December 31, 1963, for the purpose of retiring indebtness existing on such date.

SEC. 208. PERSONAL CASUALTY AND THEFT LOSSES.

(a) Limitation on Amount of Casualty or Theft Loss Deduction.—Section 165(c)(3) (relating to losses of property not connected with trade or business) is amended to read as follows:

"(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return."

(b) Effective Date.—The amendment made by subsection (a) shall apply to losses sustained after December 31, 1963, in taxable years ending after such date.

SEC. 209. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) Certain Organizations Added to Additional 10-Percent Charitable Limitation.—Section 170(b)(1)(A) (relating to limitation on amount of deduction for charitable contributions by individuals) is amended by striking out "or" at the end of clause (iii), and by inserting after clause (iv) the following new clauses:

"(v) a governmental unit referred to in subsection (c)(1), or

"(vi) an organization referred to in subsection (c)(2) which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from a governmental unit referred to in subsection (c)(1) or from direct or indirect contributions from the general public,".

(b) Unlimited Charitable Contribution Deduction.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by inserting after subsection (f) (added by subsection (e) of this section) the following new subsection:

"(g) Application of Unlimited Charitable Contribution Deduction.—

"(1) Allowance of deduction for taxable years beginning after December 31,1963.—If the taxable year begins after December 31, 1963—

"(A) subsection (b)(1)(C) shall apply only if the taxpayer so elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes); and

"(B) for purposes of subsection (b)(1)(C), the amount of the charitable contributions for the taxable year (and for all prior taxable years beginning after December 31, 1963) shall be determined without the application of subsection (b)(5) and solely by reference to charitable contributions described in paragraph (2).

If the taxpayer elects to have subsection (b)(1)(C) apply for the taxable year, then for such taxable year subsection (a) shall apply only with respect to charitable contributions described in paragraph (2), and no amount of charitable contributions made in the taxable year or any prior taxable year may be treated under subsection (b)(5) as having been made in the taxable year or in any succeeding taxable year.

"(2) Qualified contributions.—The charitable contributions referred to in paragraph (1) are—

"(A) any charitable contribution described in subsection (b)(1)(A);

"(B) any charitable contribution, not described in subsection (b)(1)(A), to an organization described in subsection (c)(2) substantially more than half of the assets of which is devoted directly to, and substantially all of the income of which is expended directly for, the active conduct of the activities constituting the purpose or function for which it is organized and operated;

"(C) any charitable contribution, not described in subsection (b)(1)(A), to an organization described in subsection (c)(2) which meets the requirements of paragraph (3) with respect to such charitable contribution; and

"(D) any charitable contribution payment of which is made on or before the date of the enactment of the Revenue Act of 1964.

"(3) Organizations expending at least 50 percent of donor's contributions.—An organization shall be an organization referred to in paragraph (2)(C), with respect to any charitable contribution, only if—

"(A) not later than the close of the third year after the organization's taxable year in which the contribution is received (or before such later time as the Secretary or his delegate may allow upon good cause shown by such organization), such organization expends an amount equal to at least 50 percent of such contribution for—

"(i) the active conduct of the activities constituting the purpose or function for which it is organized and operated,

"(ii) assets which are directly devoted to such active conduct,

"(iii) contributions to organizations which are described in subsection (b)(1)(A) or in paragraph (2)(B) of this subsection, or

"(iv) any combination of the foregoing; and

"(B) for the period beginning with the taxable year in which such contribution is received and ending with the taxable year in which subparagraph (A) is satisfied with respect to such contribution, such organization expends all of its net income (determined without regard to capital gains and losses) for the purposes described in clauses (i), (ii), (iii), and (iv) of subparagraph (A).

If the taxpayer so elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes) with respect to contributions

made by him to any organization, then, in applying subparagraph (B) with respect to contributions made by him to such organization during his taxable year for which such election is made and during all his subsequent taxable years, amounts expended by the organization after the close of any of its taxable years and on or before the 15th day of the third month following the close of such taxable year shall be treated as expended during such taxable year.

"(4) DISQUALIFYING TRANSACTIONS.—An organization shall be an organization referred to in subparagraph (B) or (C) of paragraph (2) only if at no time during the period consisting of the organization's taxable year in which the contribution is received, its 3 preceding taxable years, and its 3 succeeding taxable years, such organization—

"(A) lends any part of its income or corpus to,

"(B) pays compensation (other than reasonable compensation for personal services actually rendered) to,

"(C) makes any of its services available on a preferential basis to,

"(D) purchases more than a minimal amount of securities or other property from, or

"(E) sells more than a minimal amount of securities or other property to,

the donor of such contribution, any member of his family (as defined in section 267(c)(4)), any employee of the donor, any officer or employee of a corporation in which he owns (directly or indirectly) 50 percent or more in value of the outstanding stock, or any partner or employee of a partnership in which he owns (directly or indirectly) 50 percent or more of the capital interest or profits interest. This paragraph shall not apply to transactions occurring on or before the date of the enactment of the Revenue Act of 1964."

(c) 5-YEAR CARRYOVER OF CERTAIN CHARITABLE CONTRIBUTIONS MADE BY INDIVIDUALS.—

(1) IN GENERAL.—Section 170(b) (relating to limitations on amount of deduction for charitable contributions) is amended by adding at the end thereof the following new paragraph:

"(5) CARRYOVER OF CERTAIN EXCESS CONTRIBUTIONS BY INDIVIDUALS.—

"(A) In the case of an individual, if the amount of charitable contributions described in paragraph (1)(A) payment of which is made within a taxable year (hereinafter in this paragraph referred to as the 'contribution year') beginning after December 31, 1963, exceeds 30 percent of the taxpayer's adjusted gross income for such year (computed without regard to any net operating loss carryback to such year under section 172), such excess shall be treated as a charitable contribution described in paragraph (1)(A) paid in each of the 5 succeeding taxable years in order of time, but, with respect to any such succeeding taxable year, only to the extent of the lesser of the two following amounts:

"(i) the amount by which 30 percent of the taxpayer's adjusted gross income for such succeeding taxable year (computed without regard to any net operating loss carryback to such succeeding taxable year under section 172) exceeds the sum of the charitable contributions described in paragraph (1)(A) payment of which is made by the taxpayer within such succeeding taxable year (determined without regard to this subparagraph) and the charitable contributions described in paragraph (1)(A) payment of which was made in taxable years (beginning after December 31, 1963) before the contribution year which are treated under this subparagraph as having been paid in such succeeding taxable year; or

"(ii) in the case of the first succeeding taxable year, the amount of such excess, and in the case of the second, third, fourth, or fifth succeeding taxable year, the portion of such excess not treated under this subparagraph as a charitable contribution described in paragraph (1)(A) paid in any taxable year intervening between the contribution year and such succeeding taxable year.

"(B) In applying subparagraph (A), the excess determined under subparagraph (A) for the contribution year shall be reduced to the extent that such excess reduces taxable income (as computed for purposes of

the second sentence of section 172(b)(2)) and increases the net operating loss deduction for a taxable year succeeding the contribution year."

(2) TECHNICAL AMENDMENTS.—Sections 545(b)(2) (relating to deductions for charitable contributions by personal holding companies) and 556(b)(2) (relating to deductions for charitable contributions by foreign personal holding companies) are each amended by striking out "section 170(b)(2)" and inserting in lieu thereof "section 170(b) (2) and (5)".

(d) 5-YEAR CARRYOVER OF CERTAIN CHARITABLE CONTRIBUTIONS MADE BY CORPORATIONS.—

(1) IN GENERAL.—Section 170(b)(2) (relating to limitation on amount of deduction for charitable contributions by corporations) is amended by striking out the sentence following subparagraph (D) and inserting in lieu thereof the following:

"Any contribution made by a corporation in a taxable year (hereinafter in this sentence referred to as the 'contribution year') in excess of the amount deductible for such year under the preceding sentence shall be deductible for each of the 5 succeeding taxable years in order of time, but only to the extent of the lesser of the two following amounts: (i) the excess of the maximum amount deductible for such succeeding taxable year under the preceding sentence over the sum of the contributions made in such year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this sentence for such succeeding taxable year; or (ii) in the case of the first succeeding taxable year, the amount of such excess contribution, and in the case of the second, third, fourth, or fifth succeeding taxable year, the portion of such excess contribution not deductible under this sentence for any taxable year intervening between the contribution year and such succeeding taxable year."

(2) CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.—Paragraph (19) of section 381(c) (relating to items of distributor or transferor corporation) is amended to read as follows:

"(19) CHARITABLE CONTRIBUTIONS IN EXCESS OF PRIOR YEARS' LIMITATIONS.—Contributions made in the taxable year ending on the date of distribution or transfer and the 4 prior taxable years by the distributor or transferor corporation in excess of the amount deductible under section 170(b)(2) for such taxable years shall be deductible by the acquiring corporation for its taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170(b)(2). In applying the preceding sentence, each taxable year of the distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a prior taxable year with reference to the acquiring corporation's taxable years beginning after such date."

(e) FUTURE INTERESTS IN TANGIBLE PERSONAL PROPERTY.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by redesignating subsections (f) and (g) as subsections (h) and (i), respectively, and by inserting after subsection (e) the following new subsection:

"(f) FUTURE INTERESTS IN TANGIBLE PERSONAL PROPERTY.—For purposes of this section, payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b). For purposes of the preceding sentence, a fixture which is intended to be severed from the real property shall be treated as tangible personal property."

(f) EFFECTIVE DATES.—

(1) The amendments made by subsections (a), (b), and (c), shall apply with respect to contributions which are paid in taxable years beginning after December 31, 1963.

(2) The amendments made by subsection (d) shall apply to taxable years beginning after December 31, 1963, with respect to contributions which are paid (or treated as paid under section 170(a)(2) of the Internal Revenue Code of 1954) in taxable years beginning after December 31, 1961.

(3) The amendments made by subsection (e) shall apply to transfers of future interests made after December 31, 1963, in taxable years ending after

such date, except that such amendments shall not apply to any transfer of a future interest made before July 1, 1964, where—

(A) the sole intervening interest or right is a nontransferable life interest reserved by the donor, or

(B) in the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable life interest reserved by the donors which expires not later than the death of whichever of such donors dies later.

For purposes of the exception contained in the preceding sentence, a right to make a transfer of the reserved life interest to the donee of the future interest shall not be treated as making a life interest transferable.

SEC. 210. LOSSES ARISING FROM EXPROPRIATION OF PROPERTY BY GOVERNMENTS OF FOREIGN COUNTRIES.

(a) NET OPERATING LOSS CARRYOVER.—Section 172 (relating to net operating loss deduction) is amended—

(1) by striking out "Except as provided in clause (ii)" in subsection (b)(1)(A)(i) and inserting in lieu thereof "Except as provided in clause (ii) and in subparagraph (D)";

(2) by striking out "Except as provided in subparagraph (C)" in subsection (b)(1)(B) and inserting in lieu thereof "Except as provided in subparagraphs (C) and (D)";

(3) by adding at the end of subsection (b)(1) the following new subparagraph:

"(D) In the case of a taxpayer which has a foreign expropriation loss (as defined in subsection (k)) for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss.";

(4) by adding at the end of subsection (b)(3) the following new subparagraphs:

"(C) Paragraph (1)(D) shall apply only if—

"(i) the foreign expropriation loss (as defined in subsection (k)) for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year,

"(ii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the taxpayer elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes) to have paragraph (1)(D) apply, and

"(iii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the taxpayer elects (in such manner as the Secretary or his delegate by regulations prescribes) on or before December 31, 1965, to have paragraph (1)(D) apply.

"(D) If a taxpayer makes an election under subparagraph (C)(iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by the election—

"(i) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966,

"(ii) any deficiency attributable to the election under subparagraph (C)(iii) or to the application of clause (i) of this subparagraph may be assessed at any time before January 1, 1969, and

"(iii) refund or credit of any overpayment attributable to the election under subparagraph (C)(iii) or to the application of clause (i) of this subparagraph may be made or allowed if claim therefor is filed before January 1, 1969.";

(5) by redesignating subsection (k) as (l), and by inserting after subsection (j) the following new subsection:

"(k) FOREIGN EXPROPRIATION LOSS DEFINED.—For purposes of subsection (b)—

"(1) The term 'foreign expropriation loss' means, for any taxable year, the sum of the losses sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign

country, any political subdivision thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless shall, to the extent of any deduction allowed under section 166(a), be treated as a loss.

"(2) The portion of the net operating loss for any taxable year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such year (but not in excess of the net operating loss for such year)."

(b) TECHNICAL AMENDMENTS.—Section 172(b)(2) is amended—

(1) by striking out subparagraph (B) and inserting in lieu thereof the following:

"(B) by determining the amount of the net operating loss deduction—

"(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

"(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,"; and

(2) by adding at the end thereof the following new sentence: "For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply in respect of foreign expropriation losses (as defined in section 172(k) of the Internal Revenue Code of 1954, as amended by subsection (a)(5) of this section), sustained in taxable years ending after December 31, 1958.

SEC. 211. ONE-PERCENT LIMITATION ON MEDICINE AND DRUGS.

(a) GENERAL RULE.—Subsection (b) of section 213 (relating to medical, dental, etc., expenses) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to amounts paid for the care of—

"(1) the taxpayer and his spouse, if either of them has attained the age of 65 before the close of the taxable year, or

"(2) any dependent described in subsection (a)(1)(A)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1963.

SEC. 212. CARE OF DEPENDENTS.

(a) CHILD CARE ALLOWANCE.—Section 214 (relating to expenses for care of certain dependents) is amended to read as follows:

"SEC. 214. EXPENSES FOR CARE OF CERTAIN DEPENDENTS.

"(a) GENERAL RULE.—There shall be allowed as a deduction expenses paid during the taxable year by a taxpayer who is a woman or widower, or is a husband whose wife is incapacitated or is institutionalized, for the care of one or more dependents (as defined in subsection (d)(1)), but only if such care is for the purpose of enabling the taxpayer to be gainfully employed.

"(b) LIMITATIONS.—

"(1) DOLLAR LIMIT.—

"(A) Except as provided in subparagraph (B), the deduction under subsection (a) shall not exceed $600 for any taxable year.

"(B) The $600 limit of subparagraph (A) shall be increased (to an amount not above $900) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had 2 or more dependents.

"(2) WORKING WIVES AND HUSBANDS WITH INCAPACITATED WIVES.—In the case of a woman who is married and in the case of a husband whose wife is incapacitated, the deduction under subsection (a)—

"(A) shall not be allowed unless the taxpayer and his spouse file a joint return for the taxable year, and

"(B) shall be reduced by the amount (if any) by which the adjusted gross income of the taxpayer and his spouse exceeds $6,000.

This paragraph shall not apply, in the case of a woman who is married, to expenses incurred while her husband is incapable of self-support because mentally or physically defective, or, in the case of a husband whose wife is incapacitated, to expenses incurred while his wife is institutionalized if such institutionalization is for a period of at least 90 consecutive days (whether or not within one taxable year) or a shorter period if terminated by her death.

"(3) CERTAIN PAYMENTS NOT TAKEN INTO ACCOUNT.—Subsection (a) shall not apply to any amount paid to an individual with respect to whom the taxpayer is allowed for his taxable year a deduction under section 151 (relating to deductions for personal exemptions).

"(c) SPECIAL RULE WHERE WIFE IS INCAPACITATED OR INSTITUTIONALIZED.—In the case of a husband whose wife is incapacitated or is institutionalized, the deduction under subsection (a) shall be allowed only for expenses incurred while the wife was incapacitated or institutionalized (as the case may be) for a period of at least 90 consecutive days (whether or not within one taxable year) or a shorter period if terminated by her death.

"(d) DEFINITIONS.—For the purposes of this section—

"(1) DEPENDENT.—The term 'dependent' means a person with respect to whom the taxpayer is entitled to an exemption under section 151(e)(1)—

"(A) who has not attained the age of 13 years and who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer; or

"(B) who is physically or mentally incapable of caring for himself.

"(2) WIDOWER.—The term 'widower' includes an unmarried individual who is legally separated from his spouse under a decree of divorce or of separate maintenance.

"(3) INCAPACITATED WIFE.—A wife shall be considered incapacitated only (A) while she is incapable of caring for herself because mentally or physically defective, or (B) while she is institutionalized.

"(4) INSTITUTIONALIZED WIFE.—A wife shall be considered institutionalized only while she is, for the purpose of receiving medical care or treatment, an inpatient, resident, or inmate of a public or private hospital, sanitarium, or other similar institution.

"(5) DETERMINATION OF STATUS.—A woman shall not be considered as married if—

"(A) she is legally separated from her spouse under a decree of divorce or of separate maintenance at the close of the taxable year, or

"(B) she has been deserted by her spouse, does not know his whereabouts (and has not known his whereabouts at any time during the taxable year), and has applied to a court of competent jurisdiction for appropriate process to compel him to pay support or otherwise to comply with the law or a judicial order, as determined under regulations prescribed by the Secretary or his delegate."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1963.

SEC. 213. MOVING EXPENSES.

(a) DEDUCTION ALLOWED FOR MOVING EXPENSES.—

(1) Part VII of subchapter B of chapter 1 (relating to additional itemized deductions for individuals) is amended by redesignating section 217 as section 218 and by inserting after section 216 the following new section:

"SEC. 217. MOVING EXPENSES.

"(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee at a new principal place of work.

"(b) DEFINITION OF MOVING EXPENSES.—

"(1) IN GENERAL.—For purposes of this section, the term 'moving expenses' means only the reasonable expenses—

"(A) of moving household goods and personal effects from the former residence to the new residence, and

"(B) of traveling (including meals and lodging) from the former residence to the new place of residence.

"(2) INDIVIDUALS OTHER THAN TAXPAYER.—In the case of any individual other than the taxpayer, expenses referred to in paragraph (1) shall be taken into account only if such individual has both the former residence and the new residence as his principal place of abode and is a member of the taxpayer's household.

"(c) CONDITIONS FOR ALLOWANCE.—No deduction shall be allowed under this section unless—

"(1) the taxpayer's new principal place of work—

"(A) is at least 20 miles farther from his former residence than was his former principal place of work, or

"(B) if he had no former principal place of work, is at least 20 miles from his former residence, and

"(2) during the 12-month period immediately following his arrival in the general location of his new principal place of work, the taxpayer is a full-time employee, in such general location, during at least 39 weeks.

"(d) RULES FOR APPLICATION OF SUBSECTION (c)(2).—

"(1) Subsection (c)(2) shall not apply to any item to the extent that the taxpayer receives reimbursement or other expense allowance from his employer for such item.

"(2) If a taxpayer has not satisfied the condition of subsection (c)(2) before the time prescribed by law (including extensions thereof) for filing the return for the taxable year during which he paid or incurred moving expenses which would otherwise be deductible under this section, but may still satisfy such condition, then such expenses may (at the election of the taxpayer) be deducted for such taxable year not withstanding subsection (c)(2).

"(3) If—

"(A) for any taxable year moving expenses have been deducted in accordance with the rule provided in paragraph (2), and

"(B) the condition of subsection (c)(2) is not satisfied by the close of the subsequent taxable year,

then an amount equal to the expenses which were so deducted shall be included in gross income for such subsequent taxable year.

"(e) DISALLOWANCE OF DEDUCTION WITH RESPECT TO REIMBURSEMENTS NOT INCLUDED IN GROSS INCOME.—No deduction shall be allowed under this section for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item which is not included in his gross income.

"(f) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(2) The table of sections for part VII of subchapter B of chapter 1 is amended by striking out—

"Sec. 217. Cross references."

and inserting in lieu thereof the following:

"Sec 217. Moving expenses.
"Sec. 218. Cross references."

(b) ADJUSTED GROSS INCOME.—Section 62 (defining adjusted gross income) is amended by inserting after paragraph (7) the following paragraph:

"(8) MOVING EXPENSE DEDUCTION.—The deduction allowed by section 217."

(c) WITHHOLDING.—Section 3401(a) (relating to definition of "wages") is amended by adding after paragraph (14) (added by section 204(b) of this Act) the following new paragraph:

"(15) to or on behalf of an employee if (and to the extent that) at the time of the payment of such remuneration it is reasonable to believe that a corresponding deduction is allowable under section 217."

(d) EFFECTIVE DATES.—The amendments made by subsections (a) and (b) shall apply to expenses incurred after December 31, 1963, in taxable years ending after such date. The amendment made by subsection (c) shall apply with respect to remuneration paid after the seventh day following the date of the enactment of this Act.

SEC. 214. 100 PERCENT DIVIDENDS RECEIVED DEDUCTION FOR MEMBERS OF ELECTING AFFILIATED GROUPS.

(a) 100 PERCENT DIVIDENDS RECEIVED DEDUCTION.—Section 243 (relating to dividends received by corporations) is amended to read as follows:

"SEC. 243. DIVIDENDS RECEIVED BY CORPORATIONS.

"(a) General Rule.—In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

"(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

"(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958; and

"(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

"(b) Qualifying Dividends.—

"(1) Definition.—For purposes of subsection (a)(3), the term 'qualifying dividends' means dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in paragraph (5) as the corporation distributing the dividends, if—

"(A) such affiliated group has made an election under paragraph (2) which is effective for the taxable years of its members which include such day, and

"(B) such dividends are distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963—

"(i) on each day of which the distributing corporation and the corporation receiving the dividends were members of such affiliated group, and

"(ii) for which an election under section 1562 (relating to election of multiple surtax exemptions) is not effective.

"(2) Election.—An election under this paragraph shall be made for an affiliated group by the common parent corporation, and shall be made for any taxable year of the common parent corporation at such time and in such manner as the Secretary or his delegate by regulations prescribes. Such election may not be made for an affiliated group for any taxable year of the common parent corporation for which an election under section 1562 is effective. Each corporation which is a member of such group at any time during its taxable year which includes the last day of such taxable year of the common parent corporation must consent to such election at such time and in such manner as the Secretary or his delegate by regulations prescribes. An election under this paragraph shall be effective—

"(A) for the taxable year of each member of such affiliated group which includes the last day of the taxable year of the common parent corporation with respect to which the election is made (except that in the case of a taxable year of a member beginning in 1963 and ending in 1964, if the election is effective for the taxable year of the common parent corporation which includes the last day of such taxable year of such member, such election shall be effective for such taxable year of such member, if such member consents to such election with respect to such taxable year), and

"(B) for the taxable year of each member of such affiliated group which ends after the last day of such taxable year of the common parent corporation but which does not include such date, unless the election is terminated under paragraph (4).

"(3) Effect of election.—If an election by an affiliated group is effective with respect to a taxable year of the common parent corporation, then under regulations prescribed by the Secretary or his delegate—

"(A) no member of such affiliated group may consent to an election under section 1562 for such taxable year,

"(B) the members of such affiliated group shall be treated as one taxpayer for purposes of making the elections under section 901(a) (relating to allowance of foreign tax credit) and section 904(b)(1) (relating to election of overall limitation), and

"(C) the members of such affiliated group shall be limited to one—

"(i) $100,000 minimum accumulated earnings credit under section 535(c)(2) or (3),

"(ii) $100,000 limitation for exploration expenditures under section 615 (a) and (b),

"(iii) $400,000 limitation for exploration expenditures under section 615(c)(1),

"(iv) $25,000 limitation on small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10), and

"(v) $100,000 exemption for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax.

"(4) TERMINATION.—An election by an affiliated group under paragraph (2) shall terminate with respect to the taxable year of the common parent corporation and with respect to the taxable years of the members of such affiliated group which include the last day of such taxable year of the common parent corporation if—

"(A) CONSENT OF MEMBERS.—Such affiliated group files a termination of such election (at such time and in such manner as the Secretary or his delegate by regulations prescribes) with respect to such taxable year of the common parent corporation, and each corporation which is a member of such affiliated group at any time during its taxable year which includes the last day of such taxable year of the common parent corporation consents to such termination, or

"(B) REFUSAL BY NEW MEMBER TO CONSENT.—During such taxable year of the common parent corporation such affiliated group includes a member which—

"(i) was not a member of such group during such common parent corporation's immediately preceding taxable year, and

"(ii) such member files a statement that it does not consent to the election at such time and in such manner as the Secretary or his delegate by regulations prescribes.

"(5) DEFINITION OF AFFILIATED GROUP.—For purposes of this subsection, the term 'affiliated group' has the meaning assigned to it by section 1504(a), except that for such purposes sections 1504(b)(2) and 1504(c) shall not apply.

"(6) SPECIAL RULES FOR INSURANCE COMPANIES.—If an election under this subsection is effective for the taxable year of an insurance company subject to taxation under section 802 or 821—

"(A) part II of subchapter B of chapter 6 (relating to certain controlled corporations) shall be applied without regard to section 1563(a)(4) (relating to certain insurance companies) and section 1563(b)(2)(D) (relating to certain excluded members) with respect to such company and the other corporations which are members of the controlled group of corporations (as determined under section 1563 without regard to subsections (a)(4) and (b)(2)(D) of which such company is a member, and

"(B) for purposes of paragraph (1), a distribution by such company out of earnings and profits of a taxable year for which an election under this subsection was not effective, and for which such company was not a component member of a controlled group of corporations within the meaning of section 1563 solely by reason of section 1563(b)(2)(D), shall not be a qualifying dividend.

"(c) SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—For purposes of subsection (a)—

"(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

"(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

"(3) Any dividend received from a real estate investment trust which, for the taxable year of the trust in which the dividend is paid, qualifies under part II of subchapter M (section 856 and following) shall not be treated as a dividend.

"(4) Any dividend received which is described in section 244 (relating to dividends received on preferred stock of a public utility) shall not be treated as a dividend.

"(d) Certain Dividends From Foreign Corporations.—For purposes of subsection (a) and for purposes of section 245, any dividend from a foreign corporation from earnings and profits accumulated by a domestic corporation during a period with respect to which such domestic corporation was subject to taxation under this chapter (or corresponding provisions of prior law) shall be treated as a dividend from a domestic corporation which is subject to taxation under this chapter."

(b) Technical Amendments.—

(1) Section 244 (relating to dividends received on certain preferred stock is amended by inserting "(a) General Rule.—" before "In case of a corporation," and by adding at the end thereof the following new subsection:

"(b) Exception.—If the dividends described in subsection (a)(1) are qualifying dividends (as defined in section 243(b)(1), but determined without regard to section 243(c)(4))—

"(1) subsection (a) shall be applied separately to such qualifying dividends, and

"(2) for purposes of subsection (a)(3), the percentage applicable to such qualifying dividends shall be 100 percent in lieu of 85 percent."

(2) Section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) is amended by striking out "243(a), 244," each place it appears therein and inserting in lieu thereof "243(a)(1), 244(a),".

(3) Section 804(a)(5) (relating to the application of section 246(b) to taxàble investment income of life insurance companies) is amended by striking out "243(a), 244," and inserting in lieu thereof "243(a)(1), 244(a),".

(4) Section 809(d)(8)(B) (relating to the application of section 246(b) to the life insurance company's share of certain dividends) is amended by striking out "243(a), 244," each place it appears therein and inserting in lieu thereof "243(a)(1), 244(a),".

(c) Effective Date.—The amendments made by subsections (a) and (b) shall apply with respect to dividends received in taxable years ending after December 31, 1963.

SEC. 215. INTEREST ON LOANS INCURRED TO PURCHASE CERTAIN INSURANCE AND ANNUITY CONTRACTS.

(a) Disallowance of Interest Deduction.—Section 264(a) (relating to certain amounts paid in connection with insurance contracts) is amended—

(1) by inserting after paragraph (2) the following new paragraph:

"(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)."

(2) by adding at the end thereof the following new sentence: "Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963."

(b) Exceptions.—Section 264 is amended by adding at the end thereof the following new subsection:

"(c) Exceptions.—Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

"(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

"(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100,

"(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

"(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to amounts paid or accrued in taxable years beginning after December 31, 1963.

SEC. 216. INTEREST ON INDEBTEDNESS INCURRED OR CONTINUED TO PURCHASE OR CARRY TAX-EXEMPT BONDS.

(a) APPLICATION WITH RESPECT TO CERTAIN FINANCIAL INSTITUTIONS.—Section 265 (relating to expenses and interest relating to tax-exempt income) is amended by adding at the end of paragraph (2) the following new sentence: "In applying the preceding sentence to a financial institution (other than a bank) which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and which is subject to the banking laws of the State in which such institution is incorporated, interest on face-amount certificates (as defined in section 2(a)(15) of such Act) issued by such institution, and interest on amounts received for the purchase of such certificates to be issued by such institution, shall not be considered as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle, to the extent that the average amount of such obligations held by such institution during the taxable year (as determined under regulations prescribed by the Secretary or his delegate) does not exceed 15 percent of the average of the total assets held by such institution during the taxable year (as so determined)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years ending after the date of the enactment of this Act.

SEC. 217. LIMITATION OF TRAVEL ALLOCATION REQUIREMENT TO FOREIGN TRAVEL.

(a) LIMITATIONS OF APPLICATION OF SECTION 274(c).—Section 274(c) (relating to traveling) is amended to read as follows:

"(c) CERTAIN FOREIGN TRAVEL.—

"(1) IN GENERAL.—In the case of any individual who travels outside the United States away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary or his delegate, is not allocable to such trade or business or to such activity.

"(2) EXCEPTION.—Paragraph (1) shall not apply to the expenses of any travel outside the United States away from home if—

"(A) such travel does not exceed one week, or

"(B) the portion of the time of travel outside the United States away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time on such travel.

"(3) DOMESTIC TRAVEL EXCLUDED.—For purposes of this subsection, travel outside the United States does not include any travel from one point in the United States to another point in the United States."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

SEC. 218. ACQUISITION OF STOCK IN EXCHANGE FOR STOCK OF CORPORATION WHICH IS IN CONTROL OF ACQUIRING CORPORATION.

(a) DEFINITION OF REORGANIZATION.—Section 368(a)(1) (relating to definition of reorganization) is amended by inserting after "voting stock" in subparagraph (B) "(or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation)".

(b) TECHNICAL AMENDMENTS.—

(1) Section 368(a)(2)(C) (relating to special rules) is amended to read as follows:

(C) TRANSFERS OF ASSETS OR STOCK TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1)(A), (1)(B), AND (1)(C) CASES.—A transaction otherwise

qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock."

(2) Section 368(b) (relating to definition of party to a reorganization) is amended by striking out the last two sentences and inserting in lieu thereof the following: "In the case of a reorganization qualifying under paragraph (1)(B) or (1)(C) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term 'a party to a reorganization' includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term 'a party to a reorganization' includes the corporation controlling the corporation to which the acquired assets or stock are transferred."

(c) Effective Date.—The amendments made by this section shall apply with respect to transactions after December 31, 1963, in taxable years ending after such date.

SEC. 219. RETROACTIVE QUALIFICATION OF CERTAIN UNION-NEGOTIATED MULTI-EMPLOYER PENSION PLANS.

(a) Beginning of Period as Qualified Trust.—Section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by redesignating subsection (i) as subsection (j), and by inserting after subsection (h) the following new subsection:

"(i) Certain Union-Negotiated Multiemployer Pension Plans.—In the case of a trust forming part of a pension plan which has been determined by the Secretary or his delegate to constitute a qualified trust under subsection (a) and to be exempt from taxation under section 501(a) for a period beginning after contributions were first made to or for such trust, if it is shown to the satisfaction of the Secretary or his delegate that—

"(1) such trust was created pursuant to a collective bargaining agreement between employee representatives and two or more employers who are not related (determined under regulations prescribed by the Secretary or his delegate),

"(2) any disbursements of contributions, made to or for such trust before the time as of which the Secretary or his delegate determined that the trust constituted a qualified trust, substantially complied with the terms of the trust, and the plan of which the trust is a part, as subsequently qualified, and

"(3) before the time as of which the Secretary or his delegate determined that the trust constitutes a qualified trust, the contributions to or for such trust were not used in a manner which would jeopardize the interests of its beneficiaries,

then such trust shall be considered as having constituted a qualified trust under subsection (a) and as having been exempt from taxation under section 501(a) for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to this subsection) a qualified trust under subsection (a)."

(b) Effective Date.—The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954.

SEC. 220. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS.

(a) Employees of Foreign Subsidiaries Covered by Social Security Agreements.—Part I of subchapter D of chapter 1 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by adding at the end thereof the following new section:

"SEC. 406. CERTAIN EMPLOYEES OF FOREIGN SUBSIDIARIES.

"(a) Treatment as Employees of Domestic Corporation.—For purposes of applying this part with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic corporation, an individual who is a citizen of the United States and who is an employee of a foreign subsidiary (as defined in section 3121(l)(8)) of such domestic corporation shall be treated as an employee of such domestic corporation, if—

"(1) such domestic corporation has entered into an agreement under section 3121(l) which applies to the foreign subsidiary of which such individual is an employee;

"(2) the plan of such domestic corporation expressly provides for contributions or benefits for individuals who are citizens of the United States and who are employees of its foreign subsidiaries to which an agreement entered into by such domestic corporation under section 3121(l) applies; and

"(3) contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) are not provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary.

"(b) Special Rules for Application of Section 401(a).—

"(1) Nondiscrimination requirements.—For purposes of applying paragraphs (3)(B) and (4) of section 401(a) with respect to an individual who is treated as an employee of a domestic corporation under subsection (a)—

"(A) if such individual is an officer, shareholder, or person whose principal duties consist in supervising the work of other employees of a foreign subsidiary of such domestic corporation, he shall be treated as having such capacity with respect to such domestic corporation; and

"(B) the determination of whether such individual is a highly compensated employee shall be made by treating such individual's total compensation (determined with the application of paragraph (2) of this subsection) as compensation paid by such domestic corporation and by determining such individual's status with regard to such domestic corporation.

"(2) Determination of compensation.—For purposes of applying paragraph (5) of section 401(a) with respect to an individual who is treated as an employee of a domestic corporation under subsection (a)—

"(A) the total compensation of such individual shall be the remuneration paid to such individual by the foreign subsidiary which would constitute his total compensation if his services had been performed for such domestic corporation, and the basic or regular rate of compensation of such individual shall be determined under regulations prescribed by the Secretary or his delegate; and

"(B) such individual shall be treated as having paid the amount paid by such domestic corporation which is equivalent to the tax imposed by section 3101.

"(c) Termination of Status as Deemed Employee Not To Be Treated as Separation From Service for Purposes of Capital Gain Provisions.—For purposes of applying section 402(a)(2) and section 403(a)(2) with respect to an individual who is treated as an employee of a domestic corporation under subsection (a), such individual shall not be considered as separated from the service of such domestic corporation solely by reason of the fact that—

"(1) the agreement entered into by such domestic corporation under section 3121(l) which covers the employment of such individual is terminated under the provisions of such section,

"(2) such individual becomes an employee of a foreign subsidiary with respect to which such agreement does not apply.

"(3) such individual ceases to be an employee of the foreign subsidiary by reason of which he is treated as an employee of such domestic corporation, if he becomes an employee of another corporation controlled by such domestic corporation, or

"(4) the provision of the plan described in subsection (a)(2) is terminated.

"(d) Deductibility of Contributions.—For purposes of applying sections 404 and 405(c) with respect to contributions made to or under a pension, profit-sharing, stock bonus, annuity, or bond purchase plan by a domestic corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an individual who is treated as an employee of such domestic corporation under subsection (a)—

"(1) except as provided in paragraph (2), no deduction shall be allowed to such domestic corporation or to any other corporation which is entitled to deduct its contributions under such sections,

"(2) there shall be allowed as a deduction to the foreign subsidiary of which such individual is an employee an amount equal to the amount which (but for paragraph (1)) would be deductible under section 404 (or section 405(c)) by the domestic corporation if he were an employee of the domestic corporation, and

"(3) any reference to compensation shall be considered to be a reference to the total compensation of such individual (determined with the application of subsection (b)(2)).

Any amount deductible by a foreign subsidary under this subsection shall be deductible for its taxable year with or within which the taxable year of such domestic corporation ends.

"(e) TREATMENT AS EMPLOYEE UNDER RELATED PROVISIONS.—An individual who is treated as an employee of a domestic corporation under subsection (a) shall also be treated as an employee of such domestic corporation, with respect to the plan described in subsection (a)(2), for purposes of applying the following provisions of this title:

"(1) Section 72(d) (relating to employees' annuities).

"(2) Section 72(f) (relating to special rules for computing employees' contributions).

"(3) Section 101(b) (relating to employees' death benefits).

"(4) Section 2039 (relating to annuities).

"(5) Section 2517 (relating to certain annuities under qualified plans)."

(b) EMPLOYEES OF DOMESTIC SUBSIDIARIES ENGAGED IN BUSINESS OUTSIDE THE UNITED STATES.—Part I of subchapter D of chapter 1 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by adding after section 406 (as added by subsection (a)) the following new section:

"SEC. 407. CERTAIN EMPLOYEES OF DOMESTIC SUBSIDIARIES ENGAGED IN BUSINESS OUTSIDE THE UNITED STATES.

"(a) TREATMENT AS EMPLOYEES OF DOMESTIC PARENT CORPORATION.—

"(1) IN GENERAL.—For purposes of applying this part with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic parent corporation, an individual who is a citizen of the United States and who is an employee of a domestic subsidiary (within the meaning of paragraph (2) of such domestic parent corporation shall be treated as an employee of such domestic parent corporation, if—

"(A) the plan of such domestic parent corporation expressly provides for contributions or benefits for individuals who are citizens of the United States and who are employees of its domestic subsidiaries; and

"(B) contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) are not provided by any other person with respect to the remuneration paid to such individual by the domestic subsidiary.

"(2) DEFINITIONS.—For purposes of this section—

"(A) DOMESTIC SUBSIDIARY.—A corporation shall be treated as a domestic subsidiary for any taxable year only if—

"(i) such corporation is a domestic corporation 80 percent or more of the outstanding voting stock of which is owned by another domestic corporation;

"(ii) 95 percent or more of its gross income for the three-year period immediately preceding the close of its taxable year which ends on or before the close of the taxable year of such other domestic corporation (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

"(iii) 90 percent or more of its gross income for such period (or such part) was derived from the active conduct of a trade or business.

If for the period (or part thereof) referred to in clauses (ii) and (iii) such corporation has no gross income the provisions of clauses (ii) and (iii) shall be treated as satisfied if it is reasonable to anticipate that, with respect to the first taxable year thereafter for which such corporation has gross income, the provisions of such clauses will be satisfied.

"(B) DOMESTIC PARENT CORPORATION.—The domestic parent corporation of any domestic subsidiary is the domestic corporation which owns

80 percent or more of the outstanding voting stock of such domestic subsidiary.

"(b) SPECIAL RULES FOR APPLICATION OF SECTION 401(a).—

"(1) NONDISCRIMINATION REQUIREMENTS.—For purposes of applying paragraphs (3)(B) and (4) of section 401(a) with respect to an individual who is treated as an employee of a domestic parent corporation under subsection (a)—

"(A) if such individual is an officer, shareholder, or person whose principal duties consist in supervising the work of other employees of a domestic subsidiary, he shall be treated as having such capacity with respect to such domestic parent corporation; and

"(B) the determination of whether such individual is a highly compensated employee shall be made by treating such individual's total compensation (determined with the application of paragraph (2) of this subsection) as compensation paid by such domestic parent corporation and by determining such individual's status with regard to such domestic parent corporation.

"(2) DETERMINATION OF COMPENSATION.—For purposes of applying paragraph (5) of section 401(a) with respect to an individual who is treated as an employee of a domestic parent corporation under subsection (a), the total compensation of such individual shall be the remuneration paid to such individual by the domestic subsidiary which would constitute his total compensation if his services had been performed for such domestic parent corporation, and the basic or regular rate of compensation of such individual shall be determined under regulations prescribed by the Secretary or his delegate.

"(c) TERMINATION OF STATUS AS DEEMED EMPLOYEE NOT TO BE TREATED AS SEPARATION FROM SERVICE FOR PURPOSES OF CAPITAL GAIN PROVISIONS.—For purposes of applying section 402(a)(2) and section 403(a)(2) with respect to an individual who is treated as an employee of a domestic parent corporation under subsection (a), such individual shall not be considered as separated from the service of such domestic parent corporation solely by reason of the fact that—

"(1) the corporation of which such individual is an employee ceases, for any taxable year, to be a domestic subsidiary within the meaning of subsection (a)(2)(A),

"(2) such individual ceases to be an employee of a domestic subsidiary of such domestic parent corporation, if he becomes an employee of another corporation controlled by such domestic parent corporation, or

"(3) the provision of the plan described in subsection (a)(1)(A) is terminated.

"(d) DEDUCTIBILITY OF CONTRIBUTIONS.—For purposes of applying sections 404 and 405(c) with respect to contributions made to or under a pension, profit-sharing, stock bonus, annuity, or bond purchase plan by a domestic parent corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an individual who is treated as an employee of such domestic corporation under subsection (a)—

"(1) except as provided in paragraph (2), no deduction shall be allowed to such domestic parent corporation or to any other corporation which is entitled to deduct its contributions under such sections,

"(2) there shall be allowed as a deduction to the domestic subsidiary of which such individual is an employee an amount equal to the amount which (but for paragraph (1)) would be deductible under section 404 (or section 405(c)) by the domestic parent corporation if he were an employee of the domestic parent corporation, and

"(3) any reference to compensation shall be considered to be a reference to the total compensation of such individual (determined with the application of subsection (b)(2)).

Any amount deductible by a domestic subsidiary under this subsection shall be deductible for its taxable year with or within which the taxable year of such domestic parent corporation ends.

"(e) TREATMENT AS EMPLOYEE UNDER RELATED PROVISIONS.—An individual who is treated as an employee of a domestic parent corporation under subsection (a) shall also be treated as an employee of such domestic parent corporation, with respect to the plan described in subsection (a)(1)(A), for purposes of applying the following provisions of this title:

"(1) Section 72(d) (relating to employees' annuities).

"(2) Section 72(f) (relating to special rules for computing employees' contributions).

"(3) Section 101(b) (relating to employees' death benefits).

"(4) Section 2039 (relating to annuities).

"(5) Section 2517 (relating to certain annuities under qualified plans)."

(c) TECHNICAL AMENDMENTS.—

(1) The table of sections for part I of subchapter D of chapter 1 is amended by adding at the end thereof the following:

(2) Section 3121(a)(5) (relating to definition of wages) is amended by striking out "or" at the end of subparagraph (A) and by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:

"(B) under or to an annuity plan which, at the time of such payment, is a plan described in section 403(a), or

"(C) under or to a bond purchase plan which, at the time of such payment, is a qualified bond purchase plan described in section 405(a);".

(3) Section 209(e) of the Social Security Act (relating to the definition of wages) is amended to read as follows:

"(e) Any payment made to, or on behalf of, an employee or his beneficiary (1) from or to a trust exempt from tax under section 165(a) of the Internal Revenue Code of 1939 at the time of such payment or, in the case of a payment after 1954, under sections 401 and 501(a) of the Internal Revenue Code of 1954, unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust, or (2) under or to an annuity plan which, at the time of such payment, meets the requirements of section 165(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939 or, in the case of a payment after 1954 and prior to 1963, the requirements of section 401(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1954, or (3) under or to an annuity plan which, at the time of any such payment after 1962, is a plan described in section 403(a) of the Internal Revenue Code of 1954, or (4) under or to a bond purchase plan which, at the time of any such payment after 1962, is a qualified bond purchase plan described in section 405(a) of the Internal Revenue Code of 1954;".

(d) EFFECTIVE DATE.—The amendments made by subsections (a), (b), and (c)(1) shall apply to taxable years ending after December 31, 1963. The amendments made by subsections (c) (2) and (3) shall apply to remuneration paid after December 31, 1962.

SEC. 221. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS.

(a) IN GENERAL.—Part II of subchapter D of chapter 1 is amended to read as follows:

"PART II—CERTAIN STOCK OPTIONS

"SEC. 421. GENERAL RULES.

"(a) EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met—

"(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

"(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

"(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

"(b) Effect of Disqualifying Disposition.—If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a), 423(a), or 424(a) except that there is a failure to meet any of the holding period requirements of section 422(a)(1), 423(a)(1), or 424(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

"(c) Exercise by Estate.—

"(1) In general.—If an option to which this part applies is exercised after the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of subsection (a) shall apply to the same extent as if the option had been exercised by the decedent, except that—

"(A) the holding period and employment requirements of sections 422(a), 423(a), and 424(a) shall not apply, and

"(B) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of sections 423(c) and 424(c)(1).

"(2) Deduction for estate tax.—If an amount is required to be included under section 422(c)(1), 423(c), or 424(c)(1) in gross income of the estate of the deceased employee or of a person described in paragraph (1), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the option. For this purpose, the deduction shall be determined under section 691(c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) were an amount included in gross income under section 691 in respect of such item of gross income.

"(3) Basis of shares acquired.—In the case of a share of stock acquired by the exercise of an option to which paragraph (1) applies—

"(A) the basis of such share shall include so much of the basis of the option as is attributable to such share; except that the basis of such share shall be reduced by the excess (if any) of (i) the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) if the employee had exercised the option on the date of his death and had held the share acquired pursuant to such exercise at the time of his death, over (ii) the amount which is includible in gross income under such section; and

"(B) the last sentence of sections 422(c)(1), 423(c), and 424(c)(1) shall apply only to the extent that the amount includible in gross income under such sections exceeds so much of the basis of the option as is attributable to such share.

"SEC. 422. QUALIFIED STOCK OPTIONS.

"(a) In General.—Subject to the provisions of subsection (c)(1), section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option if—

"(1) no disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share, and

"(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

"(b) Qualified Stock Option.—For purposes of this part, the term 'qualified stock option' means an option granted to an individual after December 31, 1963 (other than a restricted stock option granted pursuant to a contract described in section 424(c)(3)(A)), for any reason connected with his employment by a

corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

"(1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

"(2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

"(3) such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted;

"(4) except as provided in subsection (c)(1), the option price is not less than the fair market value of the stock at the time such option is granted;

"(5) such option by its terms is not exercisable while there is outstanding (within the meaning of subsection (c)(2)) any qualified stock option (or restricted stock option) which was granted, before the granting of such option, to such individual to purchase stock in his employer corporation or in a corporation which (at the time of the granting of such option) is a parent or subsidiary corporation of the employer corporation, or in a predecessor corporation of any of such corporations;

"(6) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

"(7) such individual, immediately after such option is granted, does not own stock possessing more than 5 percent of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation; except that if the equity capital of such corporation or corporations (determined at the time the option is granted) is less than $2,000,000, then, for purposes of applying the limitation of this paragraph, there shall be added to such 5 percent the percentage (not higher than 5 percent) which bears the same ratio to 5 percent as the difference between such equity capital and $2,000,000 bears to $1,000,000.

"(c) SPECIAL RULES.—

"(1) EXERCISE OF OPTION WHEN PRICE IS LESS THAN VALUE OF STOCK.—If a share of stock is transferred pursuant to the exercise by an individual of an option which fails to qualify as a qualified stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met, but there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income for the taxable year in which such option is exercised, an amount equal to the lesser of—

"(A) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

"(B) the difference between the option price and the fair market value of the share at the time of such exercise.

The basis of the share acquired shall be increased by an amount equal to the amount included in his gross income under this paragraph in the taxable year in which the exercise occurred.

"(2) CERTAIN OPTIONS TREATED AS OUTSTANDING.—For purposes of subsection (b)(5)—

"(A) any restricted stock option which is not terminated before January 1, 1965, and

"(B) any qualified stock option granted after December 31, 1963.

shall be treated as outstanding until such option is exercised in full or expires by reason of the lapse of time. For purposes of the preceding sentence, a restricted stock option granted before January 1, 1964, shall not be treated as outstanding for any period before the first day on which (under the terms of such option) it may be exercised.

"(3) OPTIONS GRANTED TO CERTAIN SHAREHOLDERS.—For purposes of subsection (b)(7)—

"(A) the term 'equity capital' means—

"(i) in the case of one corporation, the sum of its money and other property (in an amount equal to the adjusted basis of such

property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders), and

"(ii) in the case of a group of corporations consisting of a parent and its subsidiary corporations, the sum of the equity capital of each of such corporations adjusted, under regulations prescribed by the Secretary or his delegate, to eliminate the effect of intercorporate ownership and transactions among such corporations;

"(B) the rules of section 425(d) shall apply in determining the stock ownership of the individual; and

"(C) stock which the individual may purchase under outstanding options shall be treated as stock owned by such individual.

If an individual is granted an option which permits him to purchase stock in excess of the limitation of subsection (b)(7) (determined by applying the rules of this paragraph), such option shall be treated as meeting the requirement of subsection (b)(7) to the extent that such individual could, if the option were fully exercised at the time of grant, purchase stock under such option without exceeding such limitation. The portion of such option which is treated as meeting the requirement of subsection (b)(7) shall be deemed to be that portion of the option which is first exercised.

"(4) CERTAIN DISQUALIFYING DISPOSITIONS WHERE AMOUNT REALIZED IS LESS THAN VALUE AT EXERCISE.—If—

"(A) an individual who has acquired a share of stock by the exercise of a qualified stock option makes a disposition of such share within the 3-year period described in subsection (a)(1), and

"(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual,

then the amount which is includible in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share.

"(5) CERTAIN TRANSFERS BY INSOLVENT INDIVIDUALS.—If an insolvent individual holds a share of stock acquired pursuant to his exercise of a qualified stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary, in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of his creditors in such proceeding, shall constitute a 'disposition of such share' for purposes of subsection (a)(1).

"(6) APPLICATION OF SUBSECTION (b)(5) WHERE OPTIONS ARE FOR STOCK OF SAME CLASS IN SAME CORPORATION.—The requirement of subsection (b)(5) shall be considered to have been met in the case of any option (referred to in this paragraph as 'new option') granted to an individual if—

"(A) the new option and all outstanding options referred to in subsection (b)(5) are to purchase stock of the same class in the same corporation, and

"(B) the new option by its terms is not exercisable while there is outstanding (within the meaning of paragraph (2)) any qualified stock option (or restricted stock option) which was granted, before the granting of the new option, to such individual to purchase stock in such corporation at a price (determined as of the date of grant of the new option) higher than the option price of the new option.

"SEC. 423. EMPLOYEE STOCK PURCHASE PLANS.

"(a) GENERAL RULE.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963 (other than a restricted stock option granted pursuant to a plan described in section 424(c)(3)(B)), under an employee stock purchase plan (as defined in subsection (b)) if—

"(1) no disposition of such share is made by him within 2 years after the date of the granting of the option nor within 6 months after the transfer of such share to him; and

"(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, he is an employee of the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent

or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

"(b) Employee Stock Purchase Plan.—For purposes of this part, the term 'employee stock purchase plan' means a plan which meets the following requirements:

"(1) the plan provides that options are to be granted only to employees of the employer corporation or of its parent or subsidiary corporation to purchase stock in any such corporation;

"(2) such plan is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

"(3) under the terms of the plan, no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent of more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation. For purposes of this paragraph, the rules of section 425(d) shall apply in determining the stock ownership of an individual, and stock which the employee may purchase under outstanding options shall be treated as stock owned by the employee;

"(4) under the terms of the plan, options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by such corporation, except that there may be excluded—

"(A) employees who have been employed less than 2 years,

"(B) employees whose customary employment is 20 hours or less per week,

"(C) employees whose customary employment is for not more than 5 months in any calendar year, and

"(D) officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

"(5) under the terms of the plan, all employees granted such options shall have the same rights and privileges, except that the amount of stock which may be purchased by any employee under such option may bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees, and the plan may provide that no employee may purchase more than a maximum amount of stock fixed under the plan;

"(6) under the terms of the plan, the option price is not less than the lesser of—

"(A) an amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

"(B) an amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised;

"(7) under the terms of the plan, such option cannot be exercised after the expiration of—

"(A) 5 years from the date such option is granted if, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of such stock at the time of the exercise of the option, or

"(B) 27 months from the date such option is granted, if the option price is not determinable in the manner described in subparagraph (A);

"(8) under the terms of the plan, no employee may be granted an option which permits his rights to purchase stock under all such plans of his employer corporation and its parent and subsidiary corporations to accrue at a rate which exceeds $25,000 of fair market value of such stock (determined at the time such option is granted) for each calendar year in which such option is outstanding at any time. For purposes of this paragraph—

"(A) the right to purchase stock under an option accrues when the option (or any portion thereof) first becomes exercisable during the calendar year;

"(B) the right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

"(C) a right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option; and

"(9) under the terms of the plan, such option is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him.

For purposes of paragraphs (3) to (9), inclusive, where additional terms are contained in an offering made under a plan, such additional terms shall, with respect to options exercised under such offering, be treated as a part of the terms of such plan.

"(c) SPECIAL RULE WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 100 PERCENT OF VALUE OF STOCK.—If the option price of a share of stock acquired by an individual pursuant to a transfer to which subsection (a) applies was less than 100 percent of the fair market value of such share at the time such option was granted, then, in the event of any disposition of such share by him which meets the holding period requirements of subsection (a), or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies, an amount equal to the lesser of—

"(1) the excess of the fair market value of the share at the time of such disposition or death over the amount paid for the share under the option, or

"(2) the excess of the fair market value of the share at the time the option was granted over the option price.

If the option price is not fixed or determinable at the time the option is granted, then for purposes of this subsection, the option price shall be determined as if the option were exercised at such time. In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount, so includible in his gross income.

"SEC. 424. RESTRICTED STOCK OPTIONS.

"(a) IN GENERAL.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option, if—

"(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, and

"(2) at the time he exercises such option—

"(A) he is an employee of either the corporation granting such option. a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

"(B) he ceased to be an employee of such corporations within the 3-month period preceding the time of exercise.

"(b) RESTRICTED STOCK OPTION.—For purposes of this part, the term 'restricted stock option' means an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of subsection (c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

"(1) at the time such option is granted—

"(A) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

"(B) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted;

"(2) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him;

"(3) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This paragraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value

of the stock subject to the option, and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after August 16, 1954. For purposes of this paragraph, the provisions of section 425(d) shall apply in determining the stock ownership of an individual; and

"(4) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

"(c) SPECIAL RULES.—

"(1) OPTIONS UNDER WHICH OPTION PRICE IS BETWEEN 85 PERCENT AND 95 PERCENT OF VALUE OF STOCK.—If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subsection (b)(1)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

"(A) in the case of a share of stock acquired under an option qualifying under subsection (b)(1)(A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

"(i) the fair market value of the share at the time of such disposition or death, or

"(ii) the fair market value of the share at the time the option was granted; or

"(B) in the case of stock acquired under an option qualifying under subsection (b)(1)(B), an amount equal to the lesser of—

"(i) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

"(ii) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of a disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

"(2) VARIABLE PRICE OPTION.—For purposes of subsection (b)(1), the term 'variable price option' means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

"(3) CERTAIN OPTIONS GRANTED AFTER DECEMBER 31, 1963.—For purposes of subsection (b), an option granted after December 31, 1963, meets the requirements of this paragraph if granted pursuant to—

"(A) a binding written contract entered into before January 1, 1964, or

"(B) a written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

"(i) met the requirements of paragraphs (4) and (5) of section 423(b), or

"(ii) was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

"SEC. 425. DEFINITIONS AND SPECIAL RULES.

"(a) CORPORATE REORGANIZATIONS, LIQUIDATIONS, ETC.—For purposes of this part, the term 'issuing or assuming a stock option in a transaction to which section 425(a) applies' means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

"(1) the excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

"(2) the new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

"(b) ACQUISITION OF NEW STOCK.—For purposes of this part, if stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies, and such distribution was made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

"(c) DISPOSITION.—

"(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of this part, the term 'disposition' includes a sale, exchange, gift, or a transfer of legal title, but does not include—

"(A) a transfer from a decedent to an estate or a transfer by bequest or inheritance;

"(B) an exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

"(C) a mere pledge or hypothecation.

"(2) JOINT TENANCY.—The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

"(d) ATTRIBUTION OF STOCK OWNERSHIP.—For purposes of this part, in applying the percentage limitations of sections 422(b)(7), 423(b)(3), and 424(b)(3)—

"(1) the individual with respect to whom such limitation is being determined shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

"(2) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

"(e) PARENT CORPORATION.—For purposes of this part, the term 'parent corporation' means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

"(f) SUBSIDIARY CORPORATION.—For purposes of this part, the term 'subsidiary corporation' means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

"(g) SPECIAL RULE FOR APPLYING SUBSECTIONS (e) AND (f).—In applying subsections (e) and (f) for purposes of section 422(a)(2), 423(a)(2), and 424(a)(2), there shall be substituted for the term 'employer corpo-

ration' wherever it appears in subsections (e) and (f) the term 'grantor corporation', or the term 'corporation issuing or assuming a stock option in a transaction to which section 425(a) applies', as the case may be.

"(h) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

"(1) IN GENERAL.—For purposes of this part, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal shall be considered as the granting of a new option.

"(2) SPECIAL RULES FOR SECTIONS 423 AND 424 OPTIONS.—

"(A) In the case of the transfer of stock pursuant to the exercise of an option to which section 423 or 424 applies and which has been so modified, extended, or renewed, then, except as provided in subparagraph (B), the fair market value of such stock at the time of the granting of such option shall be considered as whichever of the following is the highest:

"(i) the fair market value of such stock on the date of the original granting of the option,

"(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

"(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal.

"(B) Subparagraph (A) shall not apply with respect to a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

"(3) DEFINITION OF MODIFICATION.—The term 'modification' means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

"(A) attributable to the issuance or assumption of an option under subsection (a);

"(B) to permit the option to qualify under sections 422(b)(6), 423(b)(9), and 424(b)(2); or

"(C) in the case of an option not immediately exercisable in full, to accelerate the time at which the option may be exercised.

If a restricted stock option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

"(i) STOCKHOLDER APPROVAL.—For purposes of this part, if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

"(j) CROSS REFERENCES.—For provisions requiring the reporting of certain acts with respect to a qualified stock option, options granted under employer stock purchase plans, or a restricted stock option, see section 6039."

(b) ADMINISTRATIVE PROVISIONS.—

(1) REPORTING REQUIREMENT FOR CERTAIN OPTIONS.—Subpart A of part III of subchapter A of chapter 61 (relating to information returns) is amended by renumbering section 6039 as 6040, and by inserting after section 6038 the following new section:

"SEC. 6039. INFORMATION REQUIRED IN CONNECTION WITH CERTAIN OPTIONS.

(a) REQUIREMENT OF REPORTING.—Every corporation—

"(1) which in any calendar year transfers a share of stock to any person pursuant to such person's exercise of a qualified stock option or a restricted stock option, or

"(2) which in any calendar year records (or has by its agent recorded) a transfer of the legal title of a share of stock—

"(A) acquired by the transferor pursuant to his exercise of an option described in section 423(c) (relating to special rule where option price is between 85 percent and 100 percent of value of stock), or

"(B) acquired by the transferor pursuant to his exercise of a restricted stock option described in section 424(c)(1) (relating to options under which option price is between 85 percent and 95 percent of value of stock),

shall, for such calendar year, make a return at such time and in such manner, and setting forth such information, as the Secretary or his delegate may by regulations prescribe. For purposes of the preceding sentence, any option which a corporation treats as a qualified stock option, a restricted stock option, or an option granted under an employee stock purchase plan, shall be deemed to be such an option. A return is required by reason of a transfer described in paragraph (2) of a share only with respect to the first transfer of such share by the person who exercised the option.

"(b) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every corporation making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement setting forth such information as the Secretary or his delegate may by regulations prescribe. The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

"(c) IDENTIFICATION OF STOCK.—Any corporation which transfers any share of stock pursuant to the exercise of an option described in subsection (a)(2) shall identify such stock in a manner adequate to carry out the purposes of this section.

"(d) CROSS REFERENCES.—"For definition of—

"(1) The term 'qualified stock option', see section 422(b).

"(2) The term 'employee stock purchase plan', see section 423(b).

"(3) The term 'restricted stock option', see section 424(b)."

(2) PENALTIES FOR FAILURE TO FILE INFORMATION RETURNS.—Section 6652(a) (relating to failure to file certain information returns) is amended to read as follows:

"(a) RETURNS RELATING TO PAYMENTS OF DIVIDENDS, ETC., AND CERTAIN TRANSFERS OF STOCK.—In the case of each failure—

"(1) to file a statement of the aggregate amount of payments to another person required by section 6042(a)(1) (relating to payments of dividends aggregating $10 or more), section 6044(a)(1) (relating to payments of patronage dividends aggregating $10 or more), or section 6049(a)(1) (relating to payments of interest aggregating $10 or more),

"(2) to make a return required by section 6039(a) (relating to reporting information in connection with certain options) with respect to a transfer of stock or a transfer of legal title to stock, or

"(3) to make a return required by section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance) with respect to group-term life insurance on the life of an employee,

on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to file a statement referred to in paragraph (1) or failing to make a return referred to in paragraph (2) or (3), $10 for each such failure, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000."

(3) PENALTIES FOR FAILURE TO FURNISH STATEMENTS TO PERSONS WITH RESPECT TO WHOM RETURNS ARE FILED.—Section 6678 (relating to failure to furnish certain statements) is amended—

(A) by striking out "section 6042(c)," and inserting in lieu thereof "section 6039(b), 6042(c),"; and

(B) by striking out "section 6042(a)(1)," and inserting in lieu thereof "section 6039(a), 6042(a)(1),".

(c) TECHNICAL AMENDMENTS.—

(1) Section 402(a)(3)(B) (relating to taxability of beneficiary of employees' trust) is amended by striking out "section 421(d)(2) and (3)" and inserting in lieu thereof "subsections (e) and (f) of section 425".

(2) The last sentence of subparagraph (B) of section 691(c)(2) (relating to allowance of deduction for estate tax in case of items constituting

income in respect of a decedent) is amended to read as follows: "Such net value shall be determined with respect to the provisions of section 421(c)(2), relating to the deduction for estate tax with respect to stock options to which part II of subchapter D applies."

(d) CLERICAL AMENDMENTS.—

(1) The table of parts for subchapter D of chapter 1 is amended by striking out

"Part II. Miscellaneous provisions."

and inserting in lieu thereof the following:

"Part II. Certain stock options."

(2) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out

"Sec. 6039. Cross references."

and inserting in lieu thereof:

"Sec. 6039. Information required in connection with certain options.
"Sec. 6040. Cross references."

(e) EFFECTIVE DATES AND TRANSITION RULES.—

(1) Except as provided in paragraphs (2) and (3), the amendments made by this section shall apply to taxable years ending after December 31, 1963.

(2) The amendments made by paragraphs (1) and (3) of subsection (b), and paragraph (2) of section 6652(a) of the Internal Revenue Code of 1954 (as amended by paragraph (2) of subsection (b)), shall apply to stock transferred pursuant to options exercised on or after January 1, 1964.

(3) In the case of an option granted after December 31, 1963, and before January 1, 1965—

(A) paragraphs (1) and (2) of section 422(b) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply, and

(B) paragraph (1) of section 425(h) of such Code (as added by subsection (a)) shall not apply to any change in the terms of such option made before January 1, 1965, to permit such option to qualify under paragraphs (3), (4), and (5) of such section 422(b).

SEC. 222. SALES AT RETAIL UNDER REVOLVING CREDIT PLANS.

(a) TREATMENT UNDER INSTALLMENT METHOD.—Section 453 (relating to installment method of accounting) is amended by adding at the end thereof the following new subsection:

"(e) REVOLVING CREDIT TYPE PLANS.—For purposes of subsection (a), the term 'installment plan' includes a revolving credit type plan which provides that the purchaser of personal property at retail may pay for such property in a series of periodic payments of an agreed portion of the amounts due the seller under the plan, except that such term does not include any such plan with respect to a purchaser who uses his account primarily as an ordinary charge account."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply in respect of sales made during taxable years beginning after December 31, 1963.

SEC. 223. TIMING OF DEDUCTIONS IN CERTAIN CASES WHERE ASSERTED LIABILITIES ARE CONTESTED.

(a) TAXABLE YEAR OF DEDUCTION.—

(1) Section 461 (relating to general rule for taxable year of deduction) is amended by adding at the end thereof the following new subsection:

"(f) CONTESTED LIABILITIES.—If—

"(1) the taxpayer contests an asserted liability,

"(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

"(3) the contest with respect to the asserted liability exists after the time of the transfer, and

"(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States."

(2) Section 43 of the Internal Revenue Code of 1939 (relating to period for which deductions and credits taken) is amended by adding at the end

thereof the following new sentences: "If—

"(1) the taxpayer contests an asserted liability,

"(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

"(3) the contest with respect to the asserted liability exists after the time of the transfer, and

"(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

then the deduction shall be allowed for the taxable year of the transfer. The preceding sentence shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States."

(b) Effective Dates.—Except as provided in subsections (c) and (d)—

(1) the amendment made by subsection (a)(1) shall apply to taxable years beginning after Dcember 31, 1953, and ending after August 16, 1954, and

(2) the amendment made by subsection (a)(2) shall apply to taxable years to which the Internal Revenue Code of 1939 applies.

(c) Election as to Transfers in Taxable Years Beginning Before January 1, 1964.—

(1) The amendments made by subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if the taxpayer elects, in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, to have this paragraph apply. Such an election—

(A) must be made within one year after the date of the enactment of this Act,

(B) may not be revoked after the expiration of such one-year period, and

(C) shall apply to all transfers described in the first sentence of this paragraph (other than transfers described in paragraph (2)).

In the case of any transfer to which this paragraph applies, the deduction shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

(2) Paragraph (1) shall not apply to any transfer if the assessment of any deficiency which would result from the application of the election in respect of such transfer is, on the date of the election under paragraph (1), prevented by the operation of any law or rule of law.

(3) If the taxpayer makes an election under paragraph (1), and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or rule of law, the period within which assessment of such deficiency may be made shall not expire earlier than 2 years after the date of the enactment of this Act.

(d) Certain Other Transfers in Taxable Years Beginning Before January 1, 1964.—The amendments made by subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if—

(1) no deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and

(2) refund or credit of any overpayment which would result from the application of such amendments to such transfer is prevented by the operation of any law or rule of law.

In the case of any transfer to which this subsection applies, the deduction shall be allowed for the taxable year in which the contest with respect to such transfer is settled.

SEC. 224. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) In General.—Part III of subchapter E of chapter 1 (relating to accounting periods and methods of accounting) is amended by adding at the end thereof the following new section:

"SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

"(a) Amount Constituting Interest.—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as

interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

"(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term 'total unstated interest' means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

"(1) the sum of the payments to which this section applies which are due under the contract, over

"(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

"(c) PAYMENTS TO WHICH SECTION APPLIES.—

"(1) IN GENERAL.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitute part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

"(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

"(B) under which, using a rate provided by regulations prescribed by the Secretary or his delegate for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

"(2) TREATMENT OF EVIDENCE OF INDEBTEDNESS.—For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

"(d) PAYMENTS THAT ARE INDEFINITE AS TO TIME, LIABILITY, OR AMOUNT.—In the case of a contract for the sale or exchange of property under which the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as if it (and any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall be made at the time payment of such portion is made.

"(e) CHANGE IN TERMS OF CONTRACT.—If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, the 'total unstated interest' under the contract shall be recomputed and allocated (with adjustment for prior interest (including unstated interest) payments) under regulations prescribed by the Secretary or his delegate.

"(f) EXCEPTIONS AND LIMITATIONS.—

"(1) SALES PRICE OF $3,000 OR LESS.—This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

"(2) CARRYING CHARGES.—In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

"(3) TREATMENT OF SELLER.—In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231.

"(4) SALES OR EXCHANGES OF PATENTS.—This section shall not apply to any payments made pursuant to a transfer described in section 1235(a) (relating to sale or exchange of patents).

"(5) ANNUITIES.—This section shall not apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies."

(b) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following new item:

"Sec. 483. Interest on certain deferred payments."

(c) CERTAIN CARRYING CHARGES.—Section 163(b)(1) (relating to installment purchases where interest charge is not separately stated) is amended—

(1) by striking out "personal property is purchased" and inserting in lieu thereof "personal property or educational services are purchased"; and

(2) by adding at the end thereof the following new sentence: "For purposes of this paragraph, the term 'educational services' means any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4)) and which is provided for a student of such institution."

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963, other than any sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963. The amendments made by subsection (c) shall apply to payments made during taxable years beginning after December 31, 1963.

SEC. 225. PERSONAL HOLDING COMPANIES.

(a) PERSONAL HOLDING COMPANY TAX RATE.—Section 541 (relating to imposition of personal holding company tax) is amended by striking out "tax equal to" and all that follows and inserting in lieu thereof: "tax equal to 70 percent of the undistributed personal holding company income."

(b) DEFINITION OF PERSONAL HOLDING COMPANY.—Paragraph (1) of section 542(a) (relating to the gross income requirement for personal holding company purposes) is amended to read as follows:

"(1) ADJUSTED ORDINARY GROSS INCOME REQUIREMENT.—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and".

(c) EXCLUDED CORPORATIONS.—

(1) DOMESTIC BUILDING AND LOAN ASSOCIATIONS.—Paragraph (2) of section 542(c) (relating to corporations excepted from the definition of personal holding company) is amended to read as follows:

"(2) a bank as defined in section 581, or a domestic building and loan association within the meaning of section 7701(a)(19) without regard to subparagraphs (D) and (E) thereof;".

(2) LENDING AND FINANCE COMPANIES.—Section 542(c) is amended by striking out paragraphs (6), (7), (8), and (9), by renumbering paragraphs (10) and (11) as paragraphs (7) and (8), and by inserting after paragraph (5) the following new paragraph:

"(6) a lending or finance company if—

"(A) 60 percent or more of its ordinary gross income (as defined in section 543(b)(1)) is derived directly from the active and regular conduct of a lending or finance business;

"(B) the personal holding company income for the taxable year (computed without regard to income described in subsection (d)(3) and income derived directly from the active and regular conduct of a lending or finance business, and computed by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders) is not more than 20 percent of the ordinary gross income;

"(C) the sum of the deductions which are directly allocable to the active and regular conduct of its lending or finance business equals or exceeds the sum of—

"(i) 15 percent of so much of the ordinary gross income derived therefrom as does not exceed $500,000, plus

"(ii) 5 percent of so much of the ordinary gross income derived therefrom as exceeds $500,000 but not $1,000,000; and

"(D) the loans to a person who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544(a)(2)), outstanding at any time during such year do not exceed $5,000 in principal amount;".

(3) Special rules for section 542 (c)(6).—Section 542 is amended by adding at the end thereof the following new subsection:

"(d) Special Rules for Applying Subsection (c)(6).—

"(1) Lending or finance business defined.—

"(A) In general.—Except as provided in subparagraph (B), for purposes of subsection (c)(6), the term 'lending or finance business' means a business of—

"(i) making loans,

"(ii) purchasing or discounting accounts receivable, notes, or installment obligations,

"(iii) rendering services or making facilities available in connection with activities described in clauses (i) and (ii) carried on by the corporation rendering services or making facilities available, or

"(iv) rendering services or making facilities available to another corporation which is engaged in the lending or finance business (within the meaning of this paragraph), if such services or facilities are related to the lending or finance business (within such meaning) of such other corporation and such other corporation and the corporation rendering services or making facilities available are members of the same affiliated group (as defined in section 1504).

"(B) Exceptions.—For purposes of subparagraph (A), the term 'lending or finance business' does not include the business of—

"(i) making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, if (at the time of the loan, purchase, or discount) the remaining maturity exceeds 60 months, unless the loans, notes, or installment obligations are evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements arising out of the sale of goods or services in the course of the borrower's or transferor's trade or business, or

"(ii) making loans evidenced by, or purchasing, certificates of indebtedness issued in a series, under a trust indenture, and in registered form or with interest coupons attached.

For purposes of clause (i), the remaining maturity shall be treated as including any period for which there may be a renewal or extension under the terms of an option exercisable by the borrower.

"(2) Business deductions.—For purposes of subsection (c)(6)(C), the deductions which may be taken into account shall include only—

"(A) deductions which are allowable only by reason of section 162 or section 404, except there shall not be included any such deduction in respect of compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 544(a)(2)), and

"(B) deductions allowable under section 167, and deductions allowable under section 164 for real property taxes, but in either case only to the extent that the property with respect to which such deductions are allowable is used directly in the active and regular conduct of the lending or finance business.

"(3) Income received from certain affiliated corporations.—For purposes of subsection (c)(6)(B), in the case of a lending or finance company which meets the requirements of subsection (c)(6)(A), there shall not be treated as personal holding company income the lawful income received from a corporation which meets the requirements of subsection (c)(6) and

which is a member of the same affiliated group (as defined in section 1504) of which such company is a member."

(d) PERSONAL HOLDING COMPANY INCOME.—Subsections (a) and (b) of section 543 (relating to personal holding company income) are amended to read as follows:

"(a) GENERAL RULE.—For purposes of this subtitle, the term 'personal holding company income' means the portion of the adjusted ordinary gross income which consists of:

"(1) DIVIDENDS, ETC.—Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities. This paragraph shall not apply to—

"(A) interest constituting rent (as defined in subsection (b)(3)),

"(B) interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936, and

"(C) a dividend distribution of divested stock (as defined in subsection (e) of section 1111), but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years before the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

"(2) RENTS.—The adjusted income from rents; except that such adjusted income shall not be included if—

"(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

"(B) the sum of—

"(i) the dividends paid during the taxable year (determined under section 562),

"(ii) the dividends considered as paid on the last day of the taxable year under section 563(c) (as limited by the second sentence of section 563(b)), and

"(iii) the consent dividends for the taxable year (determined under section 565),

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

"(3) MINERAL, OIL, AND GAS ROYALTIES.—The adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if—

"(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income,

"(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

"(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than—

"(i) deductions for compensation for personal services rendered by the shareholders, and

"(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income.

"(4) COPYRIGHT ROYALTIES.—Copyright royalties; except that copyright royalties shall not be included if—

"(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any shareholder) constitute 50 percent or more of the ordinary gross income,

"(B) the personal holding company income for the taxable year computed—

"(i) without regard to copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder

owning more than 10 percent of the total outstanding capital stock of the corporation,

"(ii) without regard to dividends from any corporation in which the taxpayer owns at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C), and

"(iii) by including as personal holding company income the adjusted income from rents and the adjusted income from mineral, oil, and gas royalties,

is not more than 10 percent of the ordinary gross income, and

"(C) the sum of the deductions which are properly allocable to such royalties and which are allowable under section 162, other than—

"(i) deductions for compensation for personal services rendered by the shareholders,

"(ii) deductions for royalties paid or accrued, and

"(iii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 25 percent of the amount by which the ordinary gross income exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to copyright royalties.

For purposes of this subsection, the term 'copyright royalties' means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code (other than by reason of section 2 or 6 thereof) and to which copyright protection is also extended by the laws of any country other than the United States of America by virtue of any international treaty, convention, or agreement, or interests in any such copyrighted works, and includes payments from any person for performing rights in any such copyrighted work and payments (other than produced film rents as defined in paragraph (5)(B)) received for the use of, or right to use, films. For purposes of this paragraph, the term 'shareholder' shall include any person who owns stock within the meaning of section 544.

"(5) Produced film rents.—

"(A) Produced film rents; except that such rents shall not be included if such rents constitute 50 percent or more of the ordinary gross income.

"(B) For purposes of this section, the term 'produced film rents' means payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film.

"(6) Use of corporation property by shareholder.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (2), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) in excess of 10 percent of its ordinary gross income.

"(7) Personal service contracts.—

"(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

"(B) amounts received from the sale or disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

"(8) ESTATES AND TRUSTS.—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries).

"(b) DEFINITIONS.—For purposes of this part—

"(1) ORDINARY GROSS INCOME.—The term 'ordinary gross income' means the gross income determined by excluding—

"(A) all gains from the sale or other disposition of capital assets, and

"(B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b).

"(2) ADJUSTED ORDINARY GROSS INCOME.—The term 'adjusted ordinary gross income' means the ordinary gross income adjusted as follows:

"(A) RENTS.—From the gross income from rents (as defined in the second sentence of paragraph (3) of this subsection) subtract the amount allowable as deductions for—

"(i) exhaustion, wear and tear, obsolescence, and amortization of property other than tangible personal property which is not customarily retained by any one lessee for more than three years,

"(ii) property taxes,

"(iii) interest, and

"(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income from rents. The amount subtracted under this subparagraph shall not exceed such gross income from rents.

"(B) MINERAL ROYALTIES, ETC.—From the gross income from mineral, oil, and gas royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for—

"(i) exhaustion, wear and tear, obsolescence, amortization and depletion,

"(ii) property and severance taxes,

"(iii) interest, and

"(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income from royalties or such gross income from working interests in oil or gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interests.

"(C) INTEREST.—There shall be excluded—

"(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

"(ii) interest on a condemnation award, a judgment, and a tax refund.

"(3) ADJUSTED INCOME FROM RENTS.—The term 'adjusted income from rents' means the gross income from rents, reduced by the amount subtracted under paragraph (2)(A) of this subsection. For purposes of the preceding sentence, the term 'rents' means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (a)(6), nor copyright royalties (as defined in subsection (a)(4), nor produced film rents (as defined in subsection (a)(5)(B)).

"(4) Adjusted income from mineral, oil, and gas royalties.—The term 'adjusted income from mineral, oil, and gas royalties' means the gross income from mineral, oil, and gas royalties (including production payments and overriding royalties), reduced by the amount subtracted under paragraph (2)(B) of this subsection in respect of such royalties."

(e) Foreign Personal Holding Company Income and Stock Ownership.—Section 553 (relating to foreign personal holding company income) and section 554 (relating to stock ownership) are amended to read as follows:

"SEC. 553. FOREIGN PERSONAL HOLDING COMPANY INCOME.

"(a) Foreign Personal Holding Company Income.—For purposes of this subtitle, the term 'foreign personal holding company income' means that portion of the gross income, determined for purposes of section 552, which consists of:

"(1) Dividends, etc.—Dividends, interest, royalties, and annuities. This paragraph shall not apply to a dividend distribution of divested stock (as defined in subsection (e) of section 1111) but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years before the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

"(2) Stock and securities transactions.—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

"(3) Commodities transactions.—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This paragraph shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

"(4) Estates and trusts.—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries); and gains from the sale or other disposition of any interest in an estate or trust.

"(5) Personal service contracts.—

"(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

"(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

"(6) Use of corporation property by shareholder.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has foreign personal holding company income for the taxable year, computed without regard to this paragraph and paragraph (7), in excess of 10 percent of its gross income.

"(7) Rents.—Rents, unless constituting 50 percent or more of the gross income. For purposes of this paragraph, the term 'rents' means compensation, however designated, for the use of, or right to use, property; but does not include amounts constituting foreign personal holding company income under paragraph (6).

"(b) LIMITATION ON GROSS INCOME IN CERTAIN TRANSACTIONS.—For purposes of this part—

"(1) gross income and foreign personal holding company income determined with respect to transactions described in subsection (a)(2) (relating to gains from stock and security transactions) shall include only the excess of gains over losses from such transactions, and

"(2) gross income and foreign personal holding company income determined with respect to transactions described in subsection (a)(3) (relating to gains from commodity transactions) shall include only the excess of gains over losses from such transactions.

"SEC. 554. STOCK OWNERSHIP.

"(a) CONSTRUCTIVE OWNERSHIP.—For purposes of determining whether a corporation is a foreign personal holding company, insofar as such determination is based on stock ownership under section 552(a)(2), section 553(a)(5), or section 553(a)(6)—

"(1) STOCK NOT OWNED BY INDIVIDUAL.—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

"(2) FAMILY AND PARTNERSHIP OWNERSHIP.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

"(3) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

"(4) APPLICATION OF FAMILY-PARTNERSHIP AND OPTION RULES.—Paragraphs (2) and (3) shall be applied—

"(A) for purposes of the stock ownership requirement provided in section 552(a)(2), if, but only if, the effect is to make the corporation a foreign personal holding company;

"(B) for purposes of section 553(a)(5) (relating to personal service contracts) or of section 553(a)(6) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income.

"(5) CONSTRUCTIVE OWNERSHIP AS ACTUAL OWNERSHIP.—Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

"(6) OPTION RULE IN LIEU OF FAMILY AND PARTNERSHIP RULE.—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

"(b) CONVERTIBLE SECURITIES.—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

"(1) for purposes of the stock ownership requirement provided in section 552(a)(2), but only if the effect of the inclusion of all such securities is to make the corporation a foreign personal holding company;

"(2) for purposes of section 553(a)(5) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income; and

"(3) for purposes of section 553(a)(6) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later

date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included."

(f) DIVIDENDS-PAID DEDUCTION.—

(1) Paragraph (2) of section 316(b) (relating to special rules for dividend defined) is amended to read as follows:

"(2) DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES.—

"(A) In the case of a corporation which—

"(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

"(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term 'dividend' also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

"(B) For purposes of subparagraph (A), the term 'distribution of property, includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but—

"(i) only to the extent of the amounts distributed to distributees other than corporate shareholders, and

"(ii) only to the extent that the corporation designates such amounts as a dividend distribution and duly notifies such distributees of such designation, under regulations prescribed by the Secretary or his delegate, but

"(iii) not in excess of the sum of such distributees' allocable share of the undistributed personal holding company income for such year, computed without regard to this subparagraph or section 562(b)."

(2) Section 331(b) (relating to nonapplication of section 301) is amended by inserting after "any distribution of property" the phrase "(other than a distribution referred to in paragraph (2)(B) of section 316(b))".

(3) Section 562(b) (relating to distributions in liquidation) is amended to read as follows:

"(b) DISTRIBUTIONS IN LIQUIDATION.—

"(1) Except in the case of a personal holding company described in section 542 or a foreign personal holding company described in section 552—

"(A) in the case of amounts distributed in liquidation, the part of such distribution which is properly chargeable to earnings and profits accumulated after February 28, 1913, shall be treated as a dividend for purposes of computing the dividends paid deduction and

"(B) in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.

"(2) In the case of a complete liquidation of a personal holding company, occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan shall be treated as a dividend for purposes of computing the dividends paid deduction, to the extent that such amount is distributed to corporate distributees and represents such corporate distributees' allocable share of the undistributed personal holding company income for the taxable year of such distribution computed without regard to this paragraph and without regard to subparagraph (B) of section 316(b)(2)."

(4) Section 551(b) (relating to amount included in gross income) is amended by striking out "received as a dividend" and inserting in lieu thereof "received as a dividend (determined as if any distribution in liquidation actually made in such taxable year had not been made)".

(g) ONE-MONTH LIQUIDATION.—Section 333 (relating to election as to recognition of gain in certain liquidations) is amended by adding at the end thereof the following new subsection:

"(g) SPECIAL RULE.—

"(1) LIQUIDATIONS BEFORE JANUARY 1, 1967.—In the case of a liquidation occurring before January 1, 1967, of a corporation referred to in paragraph (3)—

"(A) the date 'December 31, 1953' referred to in subsections (e)(2) and (f) 1) shall be treated as if such date were 'December 31, 1962', and

"(B) in the case of stock in such corporation held for more than 6 months, the term 'a dividend' as used in subsection (e)(1) shall be treated as if such term were 'long-term capital gain'.

Subparagraph (B) shall not apply to any earnings and profits to which the corporation succeeds after December 31, 1963, pursuant to any corporate reorganization or pursuant to any liquidation to which section 332 applies, except earnings and profits which on December 31, 1963, constituted earnings and profits of a corporation referred to in paragraph (3), and except earnings and profits which were earned after such date by a corporation referred to in paragraph (3).

"(2) LIQUIDATIONS AFTER DECEMBER 31, 1966.—

"(A) IN GENERAL.—In the case of a liquidation occurring after December 31, 1966, of a corporation to which this subparagraph applies—

"(i) the date 'December 31, 1953' referred to in subsections (e)(2) and (f)(1) shall be treated as if such date were 'December 31, 1962', and

"(ii) so much of the gain recognized under subsection (e)(1) as is attributable to the earnings and profits accumulated after February 28, 1913, and before January 1, 1967, shall, in the case of stock in such corporation held for more than 6 months, be treated as long-term capital gain, and only the remainder of such gain shall be treated as a dividend.

Clause (ii) shall not apply to any earnings and profits to which the corporation succeeds after December 31, 1963, pursuant to any corporate reorganization or pursuant to any liquidation to which section 332 applies, except earnings and profits which on December 31, 1963, constituted earnings and profits of a corporation referred to in paragraph (3), and except earnings and profits which were earned after such date by a corporation referred to in paragraph (3).

"(B) CORPORATIONS TO WHICH APPLICABLE.—Subparagraph (A) shall apply only with respect to a corporation which is referred to in paragraph (3) and which—

"(i) on January 1, 1964, owes qualified indebtedness (as defined in section 545(c)),

"(ii) before January 1, 1968, notifies the Secretary or his delegate that it may wish to have subparagraph (A) apply to it and submits such information as may be required by regulations prescribed by the Secretary or his delegate, and

"(iii) liquidates before the close of the taxable year in which such corporation ceases to owe such qualified indebtedness or (if earlier) the taxable year referred to in subparagraph (C).

"(C) ADJUSTED POST-1963 EARNINGS AND PROFITS EXCEED QUALIFIED INDEBTEDNESS.—In the case of any corporation, the taxable year referred to in this subparagraph is the first taxable year at the close of which its adjusted post-1963 earnings and profits equal or exceed the amount of such corporation's qualified indebtedness on January 1, 1964. For purposes of the preceding sentence, the term 'adjusted post-1963 earnings and profits' means the sum of—

"(i) the earnings and profits of such corporation for taxable years beginning after December 31, 1963, without diminution by

by reason of any distributions made out of such earnings and profits, and

"(ii) the deductions allowed for taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion.

"(3) CORPORATION REFERRED TO.—For purposes of paragraphs (1) and (2), a corporation referred to in this paragraph is a corporation which for at least one of the two most recent taxable years ending before the date of the enactment of this subsection was not a personal holding company under section 542, but would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year.

"(4) MISTAKE AS TO APPLICABILITY OF SUBSECTION.—An election made under this section by a qualified electing shareholder of a corporation in which such shareholder states that such election is made on the assumption that such corporation is a corporation referred to in paragraph (3) shall have no force or effect if it is determined that the corporation is not a corporation referred to in paragraph (3)."

(h) EXCEPTION FOR CERTAIN CORPORATION.—

(1) GENERAL RULE.—Except as provided in paragraph (2), in the case of a corporation referred to in section 333(g)(3) of the Internal Revenue Code of 1954 (as added by subsection (g) of this section), the amendments made by this section (other than subsections (f) and (g)) shall not apply if there is a complete liquidation of such corporation and if the distribution of all the property under such liquidation occurs before January 1, 1966.

(2) EXCEPTION.—Paragraph (1) shall not apply to any liquidation to which section 332 of the Internal Revenue Code of 1954 applies unless—

(A) the corporate distributee (referred to in subsection (b)(1) of such section 332) in such liquidation is liquidated in a complete liquidation to which such section 332 does not apply, and

(B) the distribution of all the property under such liquidation occurs before the 91st day after the last distribution referred to in paragraph (1) and before January 1, 1966.

(i) DEDUCTION FOR AMORTIZATION OF INDEBTEDNESS.—

(1) Section 545(a) (relating to definition of undistributed personal holding company income) is amended by striking out "subsection (b)" and inserting in lieu thereof "subsections (b) and (c)."

(2) Section 545 is amended by adding at the end thereof the following new subsection:

(c) SPECIAL ADJUSTMENT TO TAXABLE INCOME.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, for purposes of subsection (a) there shall be allowed as a deduction amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness.

"(2) CORPORATIONS TO WHICH APPLICABLE.—This subsection shall apply only with respect to a corporation—

"(A) which for at least one of the two most recent taxable years ending before the date of the enactment of this subsection was not a personal holding company under section 542, but would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year, or

"(B) to the extent that it succeeds to the deduction referred to in paragraph (1) by reason of section 381(c)(15).

"(3) QUALIFIED INDEBTEDNESS.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, for purposes of this subsection the term 'qualified indebtedness' means—

"(i) the outstanding indebtedness incurred by the taxpayer after December 31, 1933, and before January 1, 1964, and

"(ii) the outstanding indebtedness incurred after December 31, 1963, for the purpose of making a payment or set-aside referred

to in paragraph (1) in the same taxable year, but, in the case of such a payment or set-aside which is made on or after the first day of the first taxable year beginning after December 31, 1963, only to the extent the deduction otherwise allowed in paragraph (1) with respect to such payment or set-aside is treated as nondeductible by reason of the election provided in paragraph (4).

"(B) EXCEPTION.—For purposes of subparagraph (A), qualified indebtedness does not include any amounts which were, at any time after December 31, 1963, and before the payment or set-aside, owed to a person who at such time owned (or was considered as owning within the meaning of section 318(a)) more than 10 percent in value of the taxpayer's outstanding stock.

"(C) REDUCTION FOR AMOUNTS IRREVOCABLY SET ASIDE.—For purposes of subparagraph (A), the qualified indebtedness with respect to a contract shall be reduced by amounts irrevocably set aside before the taxable year to pay or retire such indebtedness; and no deduction shall be allowed under paragraph (1) for payments out of amounts so set aside.

"(4) ELECTION NOT TO DEDUCT.—A taxpayer may elect, under regulations prescribed by the Secretary or his delegate, to treat as nondeductible an amount otherwise deductible under paragraph (1); but only if the taxpayer files such election on or before the 15th day of the third month following the close of the taxable year with respect to which such election applies, designating therein the amounts which are to be treated as nondeductible and specifying the indebtedness (referred to in paragraph (3)(A)(ii)) incurred for the purpose of making the payment or set-aside.

"(5) LIMITATIONS.—The deduction otherwise allowed by this subsection for the taxable year shall be reduced by the sum of—

"(A) the amount, if any, by which—

"(i) the deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion (other than such deductions which are disallowed in computing undistributed personal holding company income under subsection (b)(8)), exceed

"(ii) any reduction, by reason of this subparagraph, of the deductions otherwise allowed by this subsection for such preceding taxable years, and

"(B) the amount, if any, by which—

"(i) the deductions allowed under subsection (b)(5) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

"(ii) any reduction, by reason of this subparagraph, of the deductions otherwise allowed by this subsection for such preceding taxable years.

"(6) PRO-RATA REDUCTION IN CERTAIN CASES.—For purposes of paragraph (3)(A), if property (of a character which is subject to an allowance for exhaustion, wear and tear, obsolescence, amortization, or depletion) is disposed of after December 31, 1963, the total amounts of qualified indebtedness of the taxpayer shall be reduced pro-rata in the taxable year of such disposition by the amount, if any, by which—

"(A) the adjusted basis of such property at the time of such disposition, exceeds

"(B) the amount of qualified indebtedness which ceased to be qualified indebtedness with respect to the taxpayer by reason of the assumption of the indebtedness by the transferee."

(3) Paragraph (15) of section 381(c) (relating to carryovers in certain corporate acquisitions) is amended to read as follows:

"(15) INDEBTEDNESS OF CERTAIN PERSONAL HOLDING COMPANIES.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of subsections (b)(7) and (c) of section 545, relating to deduction with respect to payment of certain indebtedness."

(j) INCREASE IN BASIS WITH RESPECT TO CERTAIN FOREIGN PERSONAL HOLDING COMPANY STOCK OR SECURITIES.—

(1) IN GENERAL.—Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by redesignating section 1022 as section 1023 and by inserting after section 1021 the following new section:

"SEC. 1022. INCREASE IN BASIS WITH RESPECT TO CERTAIN FOREIGN PERSONAL HOLDING COMPANY STOCK OR SECURITIES.

"(a) GENERAL RULE.—The basis (determined under section 1014(b)(5), relating to basis of stock or securities in a foreign personal holding company) of a share of stock or a security, acquired from a decedent dying after December 31, 1963, of a corporation which was a foreign personal holding company for its most recent taxable year ending before the date of the decedent's death shall be increased by its proportionate share of any Federal estate tax attributable to the net appreciation in value of all of such shares and securities determined as provided in this section.

"(b) PROPORTIONATE SHARE.—For purposes of subsection (a), the proportionate share of a share of stock or of a security is that amount which bears the same ratio to the aggregate increase determined under subsection (c)(2) as the appreciation in value of such share or security bears to the aggregate appreciation in value of all such shares and securities having appreciation in value.

"(c) SPECIAL RULES AND DEFINITIONS.—For purposes of this section—

"(1) FEDERAL ESTATE TAX.—The term 'Federal estate tax' means only the tax imposed by section 2001 or 2101, reduced by any credit allowable with respect to a tax on prior transfers by section 2013 or 2102.

"(2) FEDERAL ESTATE TAX ATTRIBUTABLE TO NET APPRECIATION IN VALUE.—The Federal estate tax attributable to the net appreciation in value of all shares of stock and securities to which subsection (a) applies is that amount which bears the same ratio to the Federal estate tax as the net appreciation in value of all of such shares and securities bears to the value of the gross estate as determined under chapter 11 (including section 2032, relating to alternate valuation).

"(3) NET APPRECIATION.—The net appreciation in value of all shares and securities to which subsection (a) applies is the amount by which the fair market value of all such shares and securities exceeds the adjusted basis of such property in the hands of the decedent.

"(4) FAIR MARKET VALUE.—For purposes of this section, the term 'fair market value' means fair market value determined under chapter 11 (including section 2032, relating to alternate valuation).

"(d) LIMITATIONS.—This section shall not apply to any foreign personal holding company referred to in section 342(a)(2)."

(2) AMENDMENT OF SECTION 1016(a).—Section 1016(a) (relating to adjustments to basis) is amended by striking out the period at the end thereof and by inserting in lieu thereof a semicolon and by adding at the end thereof the following new paragraph:

"(21) to the extent provided in section 1022, relating to increase in basis for certain foreign personal holding company stock or securities."

(3) CLERICAL AMENDMENT.—The table of sections for part II of subchapter O of chapter 1 is amended by striking out

"Sec. 1022. Cross references."

and inserting in lieu thereof the following:

"Sec. 1022. Increase in basis with respect to certain foreign personal holding company stock or securities.

"Sec. 1023. Cross references."

(k) TECHNICAL AMENDMENTS.—

(1) Section 542(b) (relating to corporations filing consolidated returns) is amended by striking out "gross income" each place it appears and inserting in lieu thereof "adjusted ordinary gross income".

(2) Section 543 (relating to personal holding company income) is amended by striking out subsection (d) (relating to special adjustment on disposition of antitrust stock received as a dividend).

(3) Section 544 (relating to rules for determining stock ownership) is amended—

(A) by striking out "section 543(a)(5)" each place it appears and inserting in lieu thereof "section 543(a)(7)", and

(B) by striking out "section 543(a)(9)" each place it appears and inserting in lieu thereof "section 543(a)(4)".

(4) REAL ESTATE INVESTMENT TRUSTS.—Paragraph (6) of section 856(a) (relating to definition of real estate investment trust) is amended by striking out "gross income" and inserting in lieu thereof "adjusted ordinary gross income (as defined in section 543(b)(2))".

(5) UNINCORPORATED BUSINESS ENTERPRISES ELECTING TO BE TAXED AS DOMESTIC CORPORATIONS.—Section 1361(i) (relating to personal holding company income) is amended as follows:

"(i) PERSONAL HOLDING COMPANY INCOME.—

"(1) EXCLUDED FROM INCOME OF ENTERPRISE.—There shall be excluded from the gross income of the enterprise as to which an election has been made under subsection (a) any item of gross income (computed without regard to the adjustments provided in section 543(b) (3) or (4)) if, but for this paragraph, such item (adjusted, where applicable, as provided in section 543 (b) (3) or (4)) would constitute personal holding company income (as defined in section 543(a)) of such enterprise.

"(2) INCOME AND DEDUCTIONS OF OWNERS.—Items excluded from the gross income of the enterprise under paragraph (1), and the expenses attributable thereto, shall be treated as the income and deductions of the proprietor or partners (in accordance with their distributive shares of partnership income) of such enterprise.

"(3) DISTRIBUTIONS.—If—

"(A) the amount excluded from gross income under paragraph (2) exceeds the expenses attributable thereto, and

"(B) any portion of such excess is distributed to the proprietor or partner during the year earned,

such portion shall not be taxed as a corporate distribution. The portion of such excess not distributed during such year shall be considered as paid-in surplus or as a contribution to capital as of the close of such year."

(6) ASSESSMENT AND COLLECTION OF PERSONAL HOLDING COMPANY TAX.—Section 6501(f) (relating to personal holding company tax) is amended by striking out "gross income, described in section 543(a)," and inserting in lieu thereof "gross income and adjusted ordinary gross income, described in section 543,".

(l) EFFECTIVE DATES.—

(1) The amendments made by this section (other than by subsections (c)(1), (f), (g), and (j)) shall apply to taxable years beginning after December 31, 1963.

(2) The amendment made by subsection (c)(1) shall apply to taxable years beginning after October 16, 1962.

(3) The amendments made by subsections (f) and (g) shall apply to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963.

(4) The amendments made by subsection (j) shall apply in respect of decedents dying after December 31, 1963.

(5) Subsection (h) shall apply to taxable years beginning after December 31, 1963.

SEC. 226. TREATMENT OF PROPERTY IN CASE OF OIL AND GAS WELLS.

(a) IN GENERAL.—Section 614(b) (relating to special rule as to operating mineral interests) is amended to read as follows:

"(b) SPECIAL RULES AS TO OPERATING MINERAL INTERESTS IN OIL AND GAS WELLS.—In the case of oil and gas wells—

"(1) IN GENERAL.—Except as otherwise provided in this subsection—

"(A) all of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and

"(B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land.

"(2) ELECTION TO TREAT OPERATING MINERAL INTERESTS AS SEPARATE PROPERTIES.—If the taxpayer has more than one operating mineral interest in a single tract or parcel of land, he may elect to treat one or more of such operating mineral interests as separate properties. The taxpayer may not have more than one combination of operating mineral interests in a single tract or parcel of land. If the taxpayer makes the election provided in this

paragraph with respect to any interest in a tract or parcel of land, each operating mineral interest which is discovered or acquired by the taxpayer in such tract or parcel of land after the taxable year for which the election is made shall be treated—

"(A) if there is no combination of interests in such tract or parcel, as a separate property unless the taxpayer elects to combine it with another interest, or

"(B) if there is a combination of interests in such tract or parcel, as part of such combination unless the taxpayer elects to treat it as a separate property.

"(3) CERTAIN UNITIZATION OR POOLING ARRANGEMENTS.—

"(A) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, if one or more of the taxpayer's operating mineral interests participate, under a voluntary or compulsory unitization or pooling agreement, in a single cooperative or unit plan of operation, then for the period of such participation—

"(i) they shall be treated for all purposes of this subtitle as one property, and

"(ii) the application of paragraphs (1), (2), and (4) in respect of such interests shall be suspended.

"(B) LIMITATION.—Subparagraph (A) shall apply to a voluntary agreement only if all the operating mineral interests covered by such agreement—

"(i) are in the same deposit, or are in 2 or more deposits the joint development or production of which is logical from the standpoint of geology, convenience, economy, or conservation, and

"(ii) are in tracts or parcels of land which are contiguous or in close proximity.

"(C) SPECIAL RULE IN THE CASE OF ARRANGEMENTS ENTERED INTO IN TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1964.—If—

"(i) two or more of the taxpayer's operating mineral interests participate under a voluntary or compulsory unitization or pooling agreement entered into in any taxable year beginning before January 1, 1964, in a single cooperative or unit plan of operation,

"(ii) the taxpayer, for the last taxable year beginning before January 1, 1964, treated such interests as two or more separate properties, and

"(iii) it is determined that such treatment was proper under the law applicable to such taxable year,

such taxpayer may continue to treat such interests in a consistent manner for the period of such participation.

"(4) MANNER, TIME, AND SCOPE OF ELECTION.—

"(A) MANNER AND TIME.—Any election provided in paragraph (2) shall be made for each operating mineral interest, in the manner prescribed by the Secretary or his delegate by regulations, not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is the later: The first taxable year beginning after December 31, 1963, or the first taxable year in which any expenditure for development or operation in respect of such operating mineral interest is made by the taxpayer after the acquisition of such interest.

"(B) SCOPE.—Any election under paragraph (2) shall be for all purposes of this subtitle and shall be binding on the taxpayer for all subsequent taxable years.

"(5) TREATMENT OF CERTAIN PROPERTIES.—If, on the day preceding the first day of the first taxable year beginning after December 31, 1963, the taxpayer has any operating mineral interests which he treats under subsection (d) of this section (as in effect before the amendments made by the Revenue Act of 1964), such treatment shall be continued and shall be deemed to have been adopted pursuant to paragraphs (1) and (2) of this subsection (as amended by such Act)."

(b) TECHNICIAL AMENDMENTS.—

(1) The heading of section 614(c) is amended to read as follows:

"(c) SPECIAL RULES AS TO OPERATING MINERAL INTERESTS IN MINES.—"

(2) Paragraph (5) of section 614(c) is hereby repealed.

(3) Section 614(d) is amended to read as follows:

"(d) OPERATING MINERAL INTERESTS DEFINED.—For purposes of this section, the term 'operating mineral interest' includes only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for purposes of computing the 50 percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage."

(4) Section 614(e)(2) is amended by striking out "within the meaning of subsection (b)(3)".

(c) ALLOCATION OF BASIS IN CERTAIN CASES.—For purposes of the Internal Revenue Code of 1954—

(1) FAIR MARKET VALUE RULE.—Except as provided in paragraph (2), if a taxpayer has a section 614(b) aggregation, then the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each property included in such aggregation shall be determined by multiplying the adjusted basis of the aggregation by a fraction—

(A) the numerator of which is the fair market value of such property, and

(B) the denominator of which is the fair market value of such aggregation.

For purposes of this paragraph, the adjusted basis and the fair market value of the aggregation, and the fair market value of each property included therein, shall be determined as of the day preceding the first day of the first taxable year which begins after December 31, 1963.

(2) ALLOCATION OF ADJUSTMENTS, ETC.—If the taxpayer makes an election under this paragraph with respect to any section 614(b) aggregation, then the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each property included in such aggregation shall be the adjusted basis of such property at the time it was first included in the aggregation by the taxpayer, adjusted for that portion of those adjustments to the basis of the aggregation which are reasonably attributable to such property. If, under the preceding sentence, the total of the adjusted bases of the interests included in the aggregation exceeds the adjusted basis of the aggregation (as of the day preceding the first day of the first taxable year which begins after December 31, 1963), the adjusted bases of the properties which include such interests shall be adjusted, under regulations prescribed by the Secretary of the Treasury or his delegate, so that the total of the adjusted bases of such interests equals the adjusted basis of the aggregation. An election, under this paragraph shall be made at such time and in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(3) DEFINITIONS.—For purposes of this subsection—

(A) SECTION 614(b) AGGREGATION.—The term "section 614(b) aggregation" means any aggregation to which section 614(b)(1)(A) of the Internal Revenue Code of 1954 (as in effect before the amendments made by subsection (a) of this section) applied for the day preceding the first day of the first taxable year beginning after December 31, 1963.

(B) PROPERTY.—The term "property" has the same meaning as is applicable, under section 614 of the Internal Revenue Code of 1954, to the taxpayer for the first taxable year beginning after December 31, 1963.

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to taxable years beginning after December 31, 1963.

SEC. 227. TREATMENT OF CERTAIN IRON ORE ROYALTIES.

(a) IN GENERAL.—

(1) AMENDMENT OF SECTION 631(c).—Section 631(c) (relating to disposal of coal with a retained economic interest) is amended—

(A) by striking out the heading and inserting in lieu thereof the following:

"(c) DISPOSAL OF COAL OR DOMESTIC IRON ORE WITH A RETAINED ECONOMIC INTEREST.—";

(B) by inserting "or iron ore mined in the United States," after "coal (including lignite),";

(C) by inserting "or iron ore" after "coal" each other place it appears in section 631(c); and

(D) by adding at the end thereof the following new sentence: "This subsection shall not apply to any disposal of iron ore—

"(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b), or

"(2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore."

(2) AMENDMENT OF SECTION 1231(b).—Section 1231(b)(2) (defining property used in the trade or business) is amended to read as follows:

"(2) TIMBER, COAL, OR DOMESTIC IRON ORE.—Such term includes timber, coal, and iron ore with respect to which section 631 applies."

(3) AMENDMENT OF SECTION 272.—The text of section 272 (relating to disposal of coal) is amended by inserting "or iron ore" after "coal" each place it appears.

(b) CLERICAL AMENDMENTS.—

(1) the heading of section 631 is amended to read as follows:

"SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER, COAL, OR DOMESTIC IRON ORE."

(2) The table of sections for part III of subchapter I of chapter 1 is amended by striking out

"Sec. 631. Gain or loss in the case of timber or coal."

and inserting in lieu thereof the following:

"Sec. 631. Gain or loss in the case of timber, coal, or domestic iron ore."

(3) The heading of section 272 is amended to read as follows:

"SEC. 272. DISPOSAL OF COAL OR DOMESTIC IRON ORE."

(4) The table of sections for part IX of subchapter B of chapter 1 is amended by striking out

"Sec. 272. Disposal of coal."

and inserting in lieu thereof the following:

"Sec. 272. Disposal of coal or domestic iron ore."

(5) Section 1016(a)(15) is amended by inserting "or domestic iron ore" after "coal".

(6) Section 1402(a)(3)(B) is amended to read as follows:

"(B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 applies to such gain or loss, or"

(7) Section 211(a)(3) of the Social Security Act is amended by striking out clause (B) and inserting in lieu thereof "(B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 of the Internal Revenue Code of 1954 applies to such gain or loss,"

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

SEC. 228. INSURANCE COMPANIES.

(a) CERTAIN MUTUALIZATION DISTRIBUTIONS MADE IN 1962.—

(1) DEDUCTION FOR CERTAIN MUTUALIZATION DISTRIBUTIONS.—Section 809(d)(11) (relating to deductions in computing gain from operations in the case of certain mutualization distributions) is amended by striking out "and 1961" and inserting in lieu thereof "1961, and 1962".

(2) APPLICATION OF SECTION 815.—Section 809(g)(3) (relating to application of section 815 to certain mutualization distributions) is amended by striking out "or 1961" and inserting in lieu thereof "1961, or 1962."

(b) ACCRUAL OF BOND DISCOUNT.—

(1) LIFE INSURANCE COMPANIES.—Section 818(b) (relating to amortization of premium and accrual of discount) is amended by adding at the end thereof the following new paragraph:

"(3) EXCEPTION.—For taxable years beginning after December 31, 1962, no accrual of discount shall be required under paragraph (1) on any bond (as defined in section 171(d)), except in the case of discount which is—

"(A) interest to which section 103 applies, or

"(B) original issue discount (as defined in section 1232(b)).

For purposes of section 805(b)(3)(A), the current earnings rate for any taxable year beginning before January 1, 1963, shall be determined as if the preceding sentence applied to such taxable year."

(2) MUTUAL INSURANCE COMPANIES.—Section 822(d)(2) (relating to amortization of premium and accrual of discount) is amended by adding at the end thereof the following new sentence: "For taxable years beginning after December 31, 1962, no accrual of discount shall be required under this paragraph on any bond (as defined in section 171(d))."

(c) CONTRIBUTIONS TO QUALIFIED, ETC., PLANS.—Section 832(c)(10) (relating to deductions allowed in computing taxable income of certain insurance companies) is amended by inserting before the semicolon at the end thereof "and in part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.)".

(d) EFFECTIVE DATES.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1961. The amendment made by subsection (c) shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 229. REGULATED INVESTMENT COMPANIES.

(a) TIME FOR MAILING CERTAIN NOTICES TO SHAREHOLDERS.—The following provisions (relating to notices to shareholders by regulated investment companies) are amended by striking out "30 days", wherever appearing therein, and inserting in lieu thereof "45 days":

(1) Section 852(b)(3)(C),
(2) Section 852(b)(3)(D)(i),
(3) Section 853(c),
(4) Section 854(b)(2), and
(5) Section 855(c).

(b) CERTAIN REDEMPTIONS BY UNIT INVESTMENT TRUSTS.—Section 852 (relating to taxation of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new subsection:

"(d) DISTRIBUTIONS IN REDEMPTION OF INTERESTS IN UNIT INVESTMENT TRUSTS.—In the case of a unit investment trust—

"(1) which is registered under the Investment Company Act of 1940 and issues periodic payment plan certificates (as defined in such Act), and

"(2) substantially all of the assets of which consist of securities issued by a management company (as defined in such Act),

section 562(c) (relating to preferential dividends) shall not apply to a distribution by such trust to a holder of an interest in such trust in redemption of part or all of such interest, with respect to the net capital gain of such trust attributable to such redemption."

(c) EFFECTIVE DATES.—The amendments made by subsection (a) shall apply to taxable years of regulated investment companies ending on or after the date of the enactment of this Act. The amendment made by subsection (b) shall apply to taxable years of regulated investment companies ending after December 31, 1963.

SEC. 230. CAPITAL LOSS CARRYOVERS FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) IN GENERAL.—Section 1212 (relating to capital loss carryover) is amended—

(1) by striking out "If for any taxable year the taxpayer" and inserting in lieu thereof:

"(a) CORPORATIONS.—If for any taxable year a corporation"; and

(2) by adding at the end thereof the following new subsection:

"(b) OTHER TAXPAYERS.—

"(1) IN GENERAL.—If a taxpayer other than a corporation has a net capital loss for any taxable year beginning after December 31, 1963—

"(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

"(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

For purposes of this paragraph, in determining such excesses an amount equal to the excess of the sum allowed for the taxable year under section 1211(b) over the gains from sales or exchanges of capital assets (determined without regard to this sentence) shall be treated as a short-term capital gain in such year.

"(2) TRANSITIONAL RULE.—In the case of a taxpayer other than a corporation, there shall be treated as a short-term capital loss in the first taxable year beginning after December 31, 1963, any amount which is treated as a short-term capital loss in such year under this subchapter as in effect immediately before the enactment of the Revenue Act of 1964."

(b) TECHNICAL AMENDMENTS.—

(1) Section 1222(9) (relating to net capital gain) is amended to read as follows:

"(9) NET CAPITAL GAIN.—In the case of a corporation, the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges."

(2) The second sentence of section 1222(10) (relating to net capital loss) is amended by striking out "For the purpose" and inserting in lieu thereof "In the case of a corporation, for the purpose".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1963.

SEC. 231. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.

(a) GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

"SEC. 1250. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.

"(a) GENERAL RULE.—

"(1) ORDINARY INCOME.—Except as otherwise provided in this section, if section 1250 property is disposed of after December 31, 1963, the applicable percentage of the lower of—

"(A) the additional depreciation (as defined in subsection (b)(1)) in respect of the property, or

"(B) the excess of—

"(i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of such property (in the case of any other disposition), over

"(ii) the adjusted basis of such property,

shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the term 'applicable percentage' means 100 percent minus one percentage point for each full month the property was held after the date on which the property was held 20 full months.

"(b) ADDITIONAL DEPRECIATION DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'additional depreciation' means, in the case of any property, the depreciation adjustments in respect of such property; except that, in the case of property held more than one year, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under the straight line method of adjustment. For purposes of the preceding sentence, if a useful life (or salvage value) was used to determining the amount allowed as a deduction for any taxable year, such life (or value) shall be used in determining the depreciation adjustments which would have resulted for such year under the straight line method.

"(2) PROPERTY HELD BY LESSEE.—In the case of a lessee, in determining the depreciation adjustments which would have resulted in respect of any building erected (or other improvement made) on the leased property, or in respect of any cost of acquiring the lease, the lease period shall be treated as including all renewal periods. For purposes of the preceding sentence—

"(A) the term 'renewal period' means any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, but

"(B) the inclusion of renewal periods shall not extend the period taken into account by more than ⅔ of the period on the basis of which the depreciation adjustments were allowed.

"(3) DEPRECIATION ADJUSTMENTS.—The term 'depreciation adjustments' means, in respect of any property, all adjustments attributable to periods after December 31, 1963, reflected in the adjusted basis of such property on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for exhaustion, wear and tear, obsolescence, or amortization (other than amortization under section 168). For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any period was less than the amount allowable, the amount taken into account for such period shall be the amount allowed.

"(c) SECTION 1250 PROPERTY.—For purposes of this section, the term 'section 1250 property' means any real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167.

"(d) EXCEPTIONS AND LIMITATIONS.—

"(1) GIFTS.—Subsection (a) shall not apply to a disposition by gift.

"(2) TRANSFERS AT DEATH.—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

"(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

"(4) LIKE KIND EXCHANGES; INVOLUNTARY CONVERSIONS, ETC.—

"(A) RECOGNITION LIMIT.—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the greater of the following:

"(i) the amount of gain recognized on the disposition (determined without regard to this section), increased as provided in subparagraph (B), or

"(ii) the amount determined under subparagraph (C).

"(B) INCREASE FOR CERTAIN STOCK.—With respect to any transaction, the increase provided by this subparagraph is the amount equal to the fair market value of any stock purchased in a corporation which (but for this paragraph) would result in nonrecognition of gain under section 1033(a)(3)(A).

"(C) ADJUSTMENT WHERE INSUFFICIENT SECTION 1250 PROPERTY IS ACQUIRED.—With respect to any transaction, the amount determined under this subparagraph shall be the excess of—

"(i) the amount of gain which would (but for this paragraph) be taken into account under subsection (a)(1), over

"(ii) the fair market value (or cost in the case of a transaction described in section 1033(a)(3)) of the section 1250 property acquired in the transaction.

"(D) BASIS OF PROPERTY ACQUIRED.—In the case of property purchased by the taxpayer in a transaction described in section 1033(a)(3), in applying the last sentence of section 1033(c), such sentence shall be applied—

"(i) first solely to section 1250 properties and to the amount of gain not taken into account under subsection (a)(1) by reason of this paragraph, and

"(ii) then to all purchased properties to which such sentence applies and to the remaining gain not recognized on the transaction as if the cost of the section 1250 properties were the basis of such properties computed under clause (i).

In the case of property acquired in any other transaction to which this paragraph applies, rules consistent with the preceding sentence shall be applied under regulations prescribed by the Secretary or his delegate.

"(E) ADDITIONAL DEPRECIATION WITH RESPECT TO PROPERTY DISPOSED OF.—In the case of any transaction described in section 1031 or 1033, the additional depreciation in respect of the section 1250 property acquired which is attributable to the section 1250 property disposed of shall be an amount equal to the amount of the gain which was not taken into account under subsection (a)(1) by reason of the application of this paragraph.

"(5) SECTION 1071 AND 1081 TRANSACTIONS.—Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection and with subsections (e) and (f) shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

"(6) PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.—

"(A) IN GENERAL.—For purposes of this section, the basis of section 1250 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

"(B) ADDITIONAL DEPRECIATION.—In respect of any property described in subparagraph (A), the additional depreciation attributable to periods before the distribution by the partnership shall be—

"(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time and the applicable percentage for the property had been 100 percent, reduced by

"(ii) if section 751(b) applied to any part of such gain, the amount of such gain to which section 751(b) would have applied if the applicable percentage for the property had been 100 percent.

"(7) DISPOSITION OF PRINCIPAL RESIDENCE.—Subsection (a) shall not apply to a disposition of—

"(A) property to the extent used by the taxpayer as his principal residence (within the meaning of section 1034, relating to sale or exchange of residence), and

"(B) property in respect of which the taxpayer meets the age and ownership requirements of section 121 (relating to gains from sale or exchange of residence of individual who has attained the age of 65) but only to the extent that he meets the use requirements of such section in respect of such property.

"(e) HOLDING PERIOD.—For purposes of determining the applicable percentage under this section, the provisions of section 1223 shall not apply, and the holding period of section 1250 property shall be determined under the following rules:

"(1) BEGINNING OF HOLDING PERIOD.—The holding period of section 1250 property shall be deemed to begin—

"(A) in the case of property acquired by the taxpayer, on the day after the date of acquisition, or

"(B) in the case of property constructed, reconstructed, or erected by the taxpayer, on the first day of the month during which the property is placed in service.

"(2) PROPERTY WITH TRANSFERRED BASIS.—If the basis of property acquired in a transaction described in paragraph (1), (2), (3), or (5) of subsection (d) is determined by reference to its basis in the hands of the transferor, then the holding period of the property in the hands of the transferee shall include the holding period of the property in the hands of the transferor.

"(3) PRINCIPAL RESIDENCE.—If the basis of property acquired in a transaction described in paragraph (7) of subsection (d) is determined by reference to the basis in the hands of the taxpayer of other property, then the holding period of the property acquired shall include the holding period of such other property.

"(f) SPECIAL RULES FOR PROPERTY WHICH IS SUBSTANTIALLY IMPROVED.—

"(1) AMOUNT TREATED AS ORDINARY INCOME.—If, in the case of a disposition of section 1250 property, the property is treated as consisting of more than one element by reason of paragraph (3), then the amount taken into account under subsection (a)(1) in respect of such section 1250 property as gain from the sale or exchange of property which is neither a capital

asset nor property described in section 1231 shall be the sum of the amounts determined under paragraph (2).

"(2) ORDINARY INCOME ATTRIBUTABLE TO AN ELEMENT.—For purposes of paragraph (1), the amount taken into account for any element shall be the amount determined by multiplying—

"(A) the amount which bears the same ratio to the lower of the amounts specified in subparagraph (A) or (B) of subsection (a)(1) for the section 1250 property as the additional depreciation for such element bears to the sum of the additional depreciation for all elements, by

"(B) the applicable percentage for such element.

For purposes of this paragraph, determinations with respect to any element shall be made as if it were a separate property.

"(3) PROPERTY CONSISTING OF MORE THAN ONE ELEMENT.—In applying this subsection in the case of any section 1250 property, there shall be treated as a separate element—

"(A) each separate improvement,

"(B) if, before completion of section 1250 property, units thereof (as distinguished from improvements) were placed in service, each such unit of section 1250 property, and

"(C) the remaining property which is not taken into account under subparagraphs (A) and (B).

"(4) PROPERTY WHICH IS SUBSTANTIALLY IMPROVED.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'separate improvement' means each improvement added during the 36-month period ending on the last day of any taxable year to the capital account for the property, but only if the sum of the amounts added to such account during such period exceeds the greatest of—

"(i) 25 percent of the adjusted basis of the property,

"(ii) 10 percent of the adjusted basis of the property, determined without regard to the adjustments provided in paragraphs (2) and (3) of section 1016(a), or

"(iii) $5,000.

For purposes of clauses (i) and (ii), the adjusted basis of the property shall be determined as of the beginning of the first day of such 36-month period, or of the holding period of the property (within the meaning of subsection (e)), whichever is the later.

"(B) EXCEPTION.—Improvements in any taxable year shall be taken into account for purposes of subparagraph (A) only if the sum of the amounts added to the capital account for the property for such taxable year exceeds the greater of—

"(i) $2,000, or

"(ii) one percent of the adjusted basis referred to in subparagraph (A) (ii), determined, however, as of the beginning of such taxable year.

For purposes of this section, if the amount added to the capital account for any separate improvement does not exceed the greater of clause (i) or (ii), such improvement shall be treated as placed in service on the first day, of a calendar month, which is closest to the middle of the taxable year.

"(C) IMPROVEMENT.—The term 'improvement' means, in the case of any section 1250 property, any addition to capital account for such property after the initial acquisition or after completion of the property.

"(g) ADJUSTMENTS TO BASIS.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

"(h) APPLICATION OF SECTION.—This section shall apply notwithstanding any other provision of this subtitle."

(b) TECHNICAL AMENDMENTS.—

(1) SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS.—

(A) The heading of section 170(e) (relating to special rule for charitable contributions of section 1245 property) is amended by striking out "SECTION 1245 PROPERTY" and inserting in lieu thereof "CERTAIN PROPERTY".

(B) The text of such section 170(e) is amended by striking out "section 1245(a)" and inserting in lieu thereof "section 1245(a) or 1250(a)".

(2) Corporate distributions of property.—Subsections (b) and (d) of section 301 (relating to amount distributed) are each amended by striking out "under section 1245(a)" and inserting in lieu thereof "under section 1245(a) or 1250(a)".

(3) Effect on earnings and profits.—Paragraph (3) of section 312(c) (relating to adjustments of earnings and profits) is amended by striking out "or under section 1245(a)" and inserting in lieu thereof "or under section 1245(a) or 1250(a)".

(4) Collapsible corporations.—Paragraph (12) of section 341(e) (relating to collapsible corporations) is amended by striking out "section 1245(a)" and inserting in lieu thereof "sections 1245(a) and 1250(a)".

(5) Installment obligations in certain liquidations.—Subparagraphs (A) and (B) of section 453(d)(4) (relating to distribution of installment obligations in certain corporate liquidations) are each amended by striking out "section 1245(a)" and inserting in lieu thereof "section 1245(a) or 1250(a)".

(6) Special rule for partnerships.—Section 751(c) (relating to definition of "unrealized receivables" for purposes of subchapter K) is amended by striking out "(as defined in section 1245(a)(3))" and inserting in lieu thereof "(as defined in section 1245(a)(3)) and section 1250 property (as defined in section 1250(c))" and by striking out "to which section 1245(a)" and inserting in lieu thereof "to which section 1245(a) or 1250(a)".

(7) The table of sections for part IV of subchapter P of chapter 1 is amended by adding at the end thereof the following:

"Sec. 1250. Gain from dispositions of certain depreciable realty."

(c) Effective Date.—The amendments made by this section shall apply to dispositions after December 31, 1963, in taxable years ending after such date.

SEC. 232 AVERAGING.

(a) General Rule.—Part I of subchapter Q of chapter 1 is amended to read as follows:

"PART I—INCOME AVERAGING

"Sec. 1301. Limitation on tax.
"Sec. 1302. Definition of averagable income: related definitions.
"Sec. 1303. Eligible individuals.
"Sec. 1304. Special rules.
"Sec. 1305. Regulations.

"SEC. 1301. LIMITATION ON TAX.

"If an eligible individual has averagable income for the computation year, and if the amount of such income exceeds $3,000, then the tax imposed by section 1 for the computation year which is attributable to averagable income shall be 5 times the increase in tax under such section which would result from adding 20 percent of such income to the sum of—

"(1) 133⅓ percent of average base period income, and

"(2) the amount (if any) of the average base period capital gain net income.

"SEC. 1302. DEFINITION OF AVERAGABLE INCOME; RELATED DEFINITIONS.

"(a) Averagable Income.—For purposes of this part—

"(1) In general.—The term 'averagable income' means the amount (if any) by which adjusted taxable income exceeds 133⅓ percent of average base period income.

"(2) Adjustment in certain cases for capital gains.—If—

"(A) the average base period capital gain net income, exceeds

"(B) the capital gain net income for the computation year,

then the term 'averagable income' means the amount determined under paragraph (1), reduced by an amount equal to such excess.

"(b) Adjusted Taxable Income.—For purposes of this part, the term 'adjusted taxable income' means the taxable income for the computation year, decreased by the sum of the following amounts:

"(1) Capital gain net income for the computation year.—The amount (if any) of the capital gain net income for the computation year.

"(2) Income attributable to gifts, bequests, etc.—

"(A) In general.—The amount of net income attributable to an interest in property where such interest was received by the taxpayer as a gift, bequest, devise, or inheritance during the computation year or any base period year. This paragraph shall not apply to gifts, bequests, devises, or inheritances between husband and wife if they make a joint return, or if one of them makes a return as a surviving spouse (as defined in section 2(b)), for the computation year.

"(B) Amount of net income.—Unless the taxpayer otherwise establishes to the satisfaction of the Secretary or his delegate, the amount of net income for any taxable year attributable to an interest described in subparagraph (A) shall be deemed to be 6 percent of the fair market value of such interest (as determined in accordance with the provisions of chapter 11 or chapter 12, as the case may be).

"(C) Limitation.—This paragraph shall apply only if the sum of the net incomes attributable to interests described in subparagraph (A) exceeds $3,000.

"(D) Net income.—For purposes of this paragraph, the term 'net income' means, with respect to any interest, the excess of—

"(i) items of gross income attributable to such interest, over

"(ii) the deductions properly allocable to or chargeable against such items.

For purposes of computing such net income, capital gains and losses shall not be taken into account.

"(3) Wagering income.—The amount (if any) by which the gains from wagering transactions for the computation year exceed the losses from such transactions.

"(4) Certain amounts received by owner-employees.—The amount (if any) to which section 72(m)(5) (relating to penalties applicable to certain amounts received by owner-employees) applies.

"(c) Average Base Period Income.—For purposes of this part—

"(1) In general.—The term 'average base period income' means one-fourth of the sum of the base period incomes for the base period.

"(2) Base period income.—The base period income for any taxable year is the taxable income for such year first increased and then decreased (but not below zero) in the following order:

"(A) Taxable income shall be increased by an amount equal to the excess of—

"(i) the amount excluded from gross income under section 911 (relating to earned income from sources without the United States) and subpart D of part III of subchapter N (sec. 931 and following, relating to income from sources within possessions of the United States), over

"(ii) the deductions which would have been properly allocable to or chargeable against such amount but for the exclusion of such amount from gross income.

"(B) Taxable income shall be decreased by the capital gain net income.

"(C) If the decrease provided by paragraph (2) of subsection (b) applies to the computation year, the taxable income shall be decreased under the rules of such paragraph (2) (other than the limitation contained in subparagraph (C) thereof).

"(d) Capital Gain Net Income, Etc.—For purposes of this part—

"(1) Capital gain net income.—The term 'capital gain net income' means the amount equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss.

"(2) Average base period capital gain net income.—The term 'average base period capital gain net income' means one-fourth of the sum of the capital gain net incomes for the base period. For purposes of the preceding sentence, the capital gain net income for any base period year shall not exceed the base period income for such year computed without regard to subsection (c)(2)(B).

"(e) Other Related Definitions.—For purposes of this part—

"(1) Computation year.—The term 'computation year' means the taxable year for which the taxpayer chooses the benefits of this part.

"(2) Base period.—The term 'base period' means the 4 taxable years immediately preceding the computation year.

"(3) Base period year.—The term 'base period year' means any of the 4 taxable years immediately preceding the computation year.

"(4) Joint return.—The term 'joint return' means the return of a husband and wife made under section 6013.

"SEC. 1303. ELIGIBLE INDIVIDUALS.

"(a) General Rule.—Except as otherwise provided in this section, for purposes of this part the term 'eligible individual' means any individual who is a citizen or resident of the United States throughout the computation year.

"(b) Nonresident Alien Individuals.—For purposes of this part, an individual shall not be an eligible individual for the computation year if, at any time during such year or the base period, such individual was a nonresident alien.

"(c) Individuals Receiving Support From Others.—

"(1) In general.—For purposes of this part, an individual shall not be an eligible individual for the computation year if, for any base period year, such individual (and his spouse) furnished less than one-half of his support.

"(2) Exceptions.—Paragraph (1) shall not apply to any computation year if—

"(A) such year ends after the individual attained age 25 and, during at least 4 of his taxable years beginning after he attained age 21 and ending with his computation year, he was not a full-time student.

"(B) more than one-half of the individual's adjusted taxable income for the computation year is attributable to work performed by him in substantial part during 2 or more of the base period years, or

"(C) the individual makes a joint return for the computation year and not more than 25 percent of the aggregate adjusted gross income of such individual and his spouse for the computation year is attributable to such individual.

In applying subparagraph (C), amounts which constitute earned income (within the meaning of section 911(b)) and are community income under community property laws applicable to such income shall be taken into account as if such amounts did not constitute community income.

"(d) Student Defined.—For purposes of this section, the term 'student' means, with respect to a taxable year, an individual who during each of 5 calendar months during such taxable year—

"(1) was a full-time student at an educational institution (as defined in section 151(e)(4)); or

"(2) was pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution (as defined in section 151(e)(4)) or of a State or political subdivision of a State.

"SEC. 1304. SPECIAL RULES.

"(a) Taxpayer Must Choose Benefits.—This part shall apply to the taxable year only if the taxpayer chooses to have the benefits of this part for such taxable year. Such choice may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for the taxable year.

"(b) Certain Provisions Inapplicable.—If the taxpayer chooses the benefits of this part for the taxable year, the following provisions shall not apply to him for such year:

"(1) section 3 (relating to optional tax if adjusted gross income is less than $5,000),

"(2) section 72(n)(2) (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals),

"(3) section 911 (relating to earned income from sources without the United States), and

"(4) subpart D of part III of subchapter N (sec. 931 and following, relating to income from sources within possessions of the United States).

"(c) Failure of Certain Married Individuals To Make Joint Return, Etc.—

"(1) Application of subsection.—Paragraphs (2), (3), and (4) of this subsection shall apply in the case of any individual who was married for any base period year or the computation year; except that—

"(A) such paragraphs shall not apply in respect of a base period year if—

"(i) such individual and his spouse make a joint return, or such individual makes a return as a surviving spouse (as defined in section 2(b)), for the computation year, and

"(ii) such individual was not married to any other spouse for such base period year, and

"(B) paragraph (4) shall not apply in respect of the computation year if the individual and his spouse make a joint return for such year.

"(2) MINIMUM BASE PERIOD INCOME.—For purposes of this part, the base period income of an individual for any base period year shall not be less than 50 percent of the base period income which would result from combining his income and deductions for such year—

"(A) with the income and deductions for such year of individual who is his spouse for the computation year, or

"(B) if greater, with the income and deductions for such year of the individual who was his spouse for such base period year.

"(3) MINIMUM BASE PERIOD CAPITAL GAIN NET INCOME.—For purposes of this part, the capital gain net income of any individual for any base period year shall not be less than 50 percent of the capital gain net income which would result from combining his capital gain net income for such year (determined without regard to this paragraph) with the capital gain net income for such year (similarly determined) of the individual with whom he is required by paragraph (2) to combine his income and deductions for such year.

"(4) COMMUNITY INCOME ATTRIBUTABLE TO SERVICES.—In the case of amounts which constitute earned income (within the meaning of section 911(b)) and are community income under community propertly laws applicable to such income—

"(A) the amount taken into account for any base period year for purposes of determining base period income shall not be less than the amount which would be taken into account if such amounts did not constitute community income, and

"(B) the amount taken into account for purposes of determining adjusted taxable income for the computation year shall not exceed the amount which would be taken into account if such amounts did not constitute community income.

"(5) MARITAL STATUS.—For purposes of this subjection, section 143 shall apply in determining whether an individual is married for any taxable year.

"(d) DOLLAR LIMITATIONS IN CASE OF JOINT RETURNS.—In the case of a joint return, the $3,000 figure contained in section 1301 shall be applied to the aggregate averagable income, and the $3,000 figure contained in section 1302(b)(2)(C) shall be applied to the aggregate net incomes.

"(e) SPECIAL RULES WHERE THERE ARE CAPITAL GAINS.—

"(1) TREATMENT OF CAPITAL GAINS IN COMPUTATION YEAR.—In the case of any taxpayer who has capital gain net income for the computation year, the tax imposed by section 1 for the computation year which is attributable to the amount of such net income shall be computed—

"(A) by adding so much of the amount thereof as does not exceed average base period capital gain net income above 133⅓ percent of average base period income, and

"(B) by adding the remainder (if any) of such net income above the 20 percent of the averagable income as taken into account for purposes of computing the tax imposed by section 1 (and above the amounts (if any) referred to in subsection (f)(1)).

"(2) COMPUTATION OF ALTERNATIVE TAX.—In the case of any taxpayer who has capital gain net income for the computation year, section 1201(b) shall be treated as imposing a tax equal to the tax imposed by section 1, reduced by the amount (if any) by which—

"(A) the tax imposed by section 1 and attributable to the capital gain net income for the computation year (determined under paragraph (1)), exceeds

"(B) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

"(f) TREATMENT OF CERTAIN OTHER ITEMS.—

"(1) GIFT OR WAGERING INCOME.—The tax imposed by section 1 for the computation year which is attributable to the amounts subtracted from

taxable income under paragraphs (2) and (3) of section 1302(b) shall equal the increase in tax under section 1 which results from adding such amounts above 20 percent of the averagable income as taken into account for purposes of computing the tax imposed thereon by section 1.

"(2) SECTION 72(m)(5).—Section 72(m)(5) (relating to penalties applicable to certain amounts received by owner-employees) shall be applied as if this part had not been enacted.

"(3) OTHER ITEMS.—Except as otherwise provided in this part, the order and manner in which items of income shall be taken into account in computing the tax imposed by this chapter on the income of any eligible individual to whom section 1301 applies for any computation year shall be determined under regulations prescribed by the Secretary or his delegate.

"(g) SHORT TAXABLE YEARS.—In the case of any computation year or base period year which is a short taxable year, this part shall be applied in the manner provided in regulations prescribed by the Secretary or his delegate.

"SEC. 1305. REGULATIONS.

"The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this part."

(b) REPEAL OF SECTION 72(e)(3).—Section 72(e)(3) (relating to limit on tax attributable to receipt of lump sum) is hereby repealed.

(c) AMENDMENT OF SECTION 144.—Section 144 (relating to election of standard deduction) is amended by adding after subsection (c) (as added by 112(c)(2) of this Act) the following new subsection:

"(d) INDIVIDUALS ELECTING INCOME AVERAGING.—In the case of a taxpayer who chooses to have the benefits of part I of subchapter Q (relating to income averaging) for the taxable year—

"(1) subsection (a) shall not apply for such taxable year, and

"(2) the standard deduction shall be allowed if the taxpayer so elects in his return for such taxable year.

The Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the taxpayer on making his return fails to signify, in the manner so prescribed, his election to take the standard deduction, such failure shall be considered his election not to take the standard deduction."

(d) STATUTE OF LIMITATIONS.—Section 6511(d)(2)(B) (relating to special period of limitation with respect to net operating loss carrybacks) is amended to read as follows:

"(B) APPLICABLE RULES.—

"(i) If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carryback is otherwise prevented by the operation of any law or rule of law other than section 7122, relating to compromises, such credit or refund may be allowed or made, if claim therefor is filed within the period provided in subparagraph (A) of this paragraph. If the allowance of an application, credit, or refund of a decrease in tax determined under section 6411(b) is otherwise prevented by the operation of any law or rule of law other than section 7122, such application, credit, or refund may be allowed or made if application for a tentative carryback adjustment is made within the period provided in section 6411(a). In the case of any such claim for credit or refund or any such application for a tentative carryback adjustment, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction, and the effect of such deduction, to the extent that such deduction is affected by a carryback which was not in issue in such proceeding.

"(ii) A claim for credit or refund for a computation year (as defined in section 1302(e)(1)) shall be determined to relate to an overpayment attributable to a net operating loss carryback when such carryback relates to any base period year (as defined in section 1302(e)(3))."

(e) TECHNICAL AMENDMENTS.—The following provisions are amended by striking out "except that section 72(e)(3) shall not apply":

(1) The first sentence of section 402(a)(1) (relating to general rule for taxability of beneficiary of exempt trust).

(2) The second sentence of section 402(b) (relating to taxability of beneficiary of non-exempt trust).

(3) The second sentence of section 402(d) (relating to certain employees' annuities).

(4) Section 403(a)(1) (relating to the general rule for taxability of a beneficiary under a qualified annuity plan).

(5) The second sentence of section 403(b)(1) (relating to general rule for taxability of beneficiary, etc.).

(6) The second sentence of section 403(c) (relating to taxability of beneficiary under a nonqualified annuity).

(f) CLERICAL AMENDMENTS.—

(1) Subsection (f) of section 4 (relating to cross references to rules for optional tax) is amended by adding at the end thereof the following new paragraph:

"(3) For rule that optional tax is not to apply if individual chooses the benefits of income averaging, see section 1304(b)."

(2) Subsection (b) of section 5 (relating to cross references to special limitations on tax) is amended to read as follows:

"(b) SPECIAL LIMITATIONS ON TAX.—

"(1) For limitation on surtax attributable to sales of oil or gas properties, see section 632.

"(2) For limitation on tax in case of income of members of Armed Forces on death, see section 692.

"(3) For limitation on tax where an individual chooses the benefits of income averaging, see section 1301.

"(4) For computation of tax where taxpayer restores substantial amount held under claim of right, see section 1341.

"(5) For limitation on surtax attributable to claims against the United States involving acquisitions of property, see section 1347."

(3) The table of parts for subchapter Q of chapter 1 is amended by striking out

"Part I. Income attributable to several taxable years."

and inserting in lieu thereof

"Part I. Income averaging."

(g) EFFECTIVE DATE.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the amendments made by this section shall apply with respect to taxable years beginning after December 31, 1963.

(2) INCOME FROM AN EMPLOYMENT.—If, in a taxable year beginning after December 31, 1963, an individual or partnership receives or accrues compensation from an employment (as defined by section 1301(b) of the Internal Revenue Code of 1954 as in effect immediately before the enactment of this Act) and the employment began before February 6, 1963, the tax attributable to such compensation may, at the election of the taxpayer, be computed under the provisions of sections 1301 and 1307 of such Code as in effect immediately before the enactment of this Act. If a taxpayer so elects (at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes), he may not choose for such taxable year the benefits provided by part I of subchapter Q of chapter 1 of such Code (relating to income averaging) as amended by this Act and (if he elects to have subsection (e) of such section 1307 apply) section 170(b)(5) of such Code as amended by this Act shall not apply to charitable contributions paid in such taxable year.

SEC. 233. SMALL BUSINESS CORPORATIONS.

(a) OWNERSHIP OF CERTAIN STOCK DISREGARDED.—Section 1371 (relating to definition of small business corporation) is amended by adding at the end thereof the following new subsection:

"(d) OWNERSHIP OF CERTAIN STOCK.—For purposes of subsection (a), a corporation shall not be considered a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

"(1) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

"(2) does not have taxable income for the period included within such taxable year."

(b) Certain Distributions of Money After Close of Taxable Year.—Section 1375 (relating to special rules applicable to distributions of electing small business corporations) is amended by adding at the end thereof the following new subsection:

"(e) Certain Distributions After Close of Taxable Year.—

"(1) In general.—For purposes of this chapter, if—

"(A) a corporation makes a distribution of money to its shareholders on or before the 15th day of the third month following the close of a taxable year with respect to which it was an electing small business corporation, and

"(B) such distribution is made pursuant to a resolution of the board of directors of the corporation, adopted before the close of such taxable year, to distribute to its shareholders all or a part of the proceeds of one or more sales of capital assets, or of property described in section 1231(b), made during such taxable year,

such distribution shall, at the election of the corporation, be treated as a distribution of money made on the last day of such taxable year.

"(2) Shareholders.—An election under paragraph (1) with respect to any distribution may be made by a corporation only if each person who is a shareholder on the day the distribution is received—

"(A) owns the same proportion of the stock of the corporation on such day as he owned on the last day of the taxable year of the corporation preceding the distribution, and

"(B) consents to such election at such time and in such manner as the Secretary or his delegate shall prescribe by regulations.

"(3) Manner and time of election.—An election under paragraph (1) shall be made in such manner as the Secretary or his delegate shall prescribe by regulations. Such election shall be made not later than the time prescribed by law for filing the return for the taxable year during which the sale was made (including extensions thereof) except that, with respect to any taxable year ending on or before the date of the enactment of the Revenue Act of 1964, such election shall be made within 120 days after such date."

(c) Effective Dates.—The amendment made by subsection (a) shall apply with respect to taxable years of corporations beginning after December 31, 1962. The amendment made by subsection (b) shall apply with respect to taxable years of corporations beginning after December 31, 1957.

SEC. 234. REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS.

(a) Repeal of Tax.—Subsection (a) of section 1503 (relating to computation and payment of tax in case of consolidated returns) is amended to read as follows:

"(a) General Rule.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return."

(b) Technical and Conforming Amendments.—

(1) Section 1503 is amended by striking out subsections (b) and (c) and by relettering subsection (d) as subsection (b).

(2) Paragraph (3) of section 1503(b) (as relettered by paragraph (1)) is amended to read as follows:

"(3) Special rules.—

"(A) For purposes of paragraph (2), a corporation is a regulated public utility only if it is a regulated public utility within the meaning of subparagraph (A) (other than clauses (ii) and (iii) thereof) or (D) of section 7701(a)(33). For purposes of the preceding sentence, the limitation contained in the last two sentences of section 7701(a)(33) shall be applied as if subparagraphs (A) through (F), inclusive, of section 7701(a)(33) were limited to subparagraphs (A)(i) and (D) thereof.

"(B) For purposes of paragraph (2), the foreign countries referred to in this subparagraph include only any country from which any

public utility referred to in the first sentence of paragraph (2) derives the principal part of its income.

"(C) For purposes of this subsection, the term 'consolidated taxable income' means the consolidated taxable income computed without regard to the deduction provided by section 242 for partially tax-exempt interest."

(3) Section 7701(a) (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(33) Regulated public utility.—The term 'regulated public utility' means—

"(A) A corporation engaged in the furnishing or sale of—

"(i) electric energy, gas, water, or sewerage disposal services, or

"(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

"(iii) transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

"(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Power Commission.

"(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Interstate Commerce Commission, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Interstate Commerce Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

"(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

"(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Civil Aeronautics Board.

"(F) A corporation engaged in the furnishing or sale of transportation by common carrier by water, subject to the jurisdiction of the Interstate Commerce Commission under part III of the Interstate Commerce Act, or subject to the jurisdiction of the Federal Maritime Board under the Intercoastal Shipping Act, 1933.

"(G) A railroad corporation subject to part I of the Interstate Commerce Act, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

"(H) A common parent corporation which is a common carrier by railroad subject to part I of the Interstate Commerce Act if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described

in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

The term 'regulated public utility' does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F), inclusive. If the taxpayer establishes to the satisfaction of the Secretary or his delegate that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D)."

(4) Section 12(8) (relating to cross reference to additional tax for corporations filing consolidated returns) is hereby repealed.

(5) Paragraphs (1) and (2) of section 172(j) (relating to carryover of net operating loss for certain regulated transportation corporations) are amended to read as follows:

"(1) Definition.—For purpose of subsection (b)(1)(C), the term 'regulated transportation corporation' means a corporation—

"(A) 80 percent or more of the gross income of which (computed without regard to dividends and capital gains and losses) for the taxable year is derived from the furnishing or sale of transportation described in subparagraph (A), (C)(i), (E), or (F) of section 7701(a)(33) and taken into account for purposes of the limitation contained in the last two sentences of section 7701(a)(33),

"(B) which is described in subparagraph (G) or (H) of section 7701(a)(33), or

"(C) which is a member of a regulated transportation system.

"(2) Regulated transportation system.—For purposes of this subsection, a corporation shall be treated as a member of a regulated transportation system for a taxable year if—

"(A) it is a member of an affiliated group of corporations making a consolidated return for such taxable year, and

"(B) 80 percent or more of the aggregate gross income of the members of such affiliated group (computed without regard to dividends and capital gains and losses) for such taxable year is derived from sources described in paragraph (1)(A).

For purposes of subparagraph (B), income derived by a corporation described in subparagraph (G) or (H) of section 7701(a)(33) from leases described in subparagraph (G) thereof shall be considered as derived from sources described in paragraph (1)(A)."

(6) Section 904(g)(2) (relating to cross references for purposes of the limitation on the foreign tax credit) is amended by striking out "section 1503(d)" and inserting in lieu thereof "section 1503(b)".

(7) Section 1341(b)(2) (relating to special rules for the computation of tax where taxpayer restores substantial amount held under claim of right) is amended by striking out "(as defined in section 1503(c) without regard to paragraph (2) thereof)" and inserting in lieu thereof "(as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof)".

(8) Section 1552(a)(3) (relating to the allocation of tax liability among members of an affiliated group of corporations filing consolidated returns) is amended by striking out "(determined without regard to the 2 percent increase provided by section 1503(a))".

(c) Effective Date.—The amendments made by subsections (a) and (b) shall apply with respect to taxable years beginning after December 31, 1963.

SEC. 235. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS, ETC.

(a) IN GENERAL.—Subchapter B of chapter 6 (related rules for consolidated returns) is amended by adding at the end thereof the following new part:

"PART II—CERTAIN CONTROLLED CORPORATIONS

"Sec. 1561. Surtax exemptions in case of certain controlled corporations.
"Sec. 1562. Privilege of groups to elect multiple surtax exemptions.
"Sec. 1563. Definitions and special rules.

"SEC. 1561. SURTAX EXEMPTIONS IN CASE OF CERTAIN CONTROLLED CORPORATIONS.

"(a) GENERAL RULE.—If a corporation is a component member of a controlled group of corporations on a December 31, then for purposes of this subtitle the surtax exemption of such corporation for the taxable year which includes such December 31 shall be an amount equal to—

"(1) $25,000 divided by the number of corporations which are component members of such group on such December 31, or

"(2) if all such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan, such portion of $25,000 as is apportioned to such member in accordance with such plan.

The sum of the amounts apportioned under paragraph (2) among the component members of any controlled group shall not exceed $25,000.

"(b) CERTAIN SHORT TAXABLE YEARS.—If a corporation—

"(1) has a short taxable year which does not include a December 31, and

"(2) is a component member of a controlled group of corporations with respect to such taxable year,

then for purposes of this subtitle the surtax exemption of such corporation for such taxable year shall be an amount equal to $25,000 divided by the number of corporations which are component members of such group on the last day of such taxable year. For purposes of the preceding sentence, section 1563(b) shall be applied as if such last day were substituted for December 31.

"SEC. 1562. PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS.

"(a) ELECTION OF MULTIPLE SURTAX EXEMPTIONS.—

"(1) IN GENERAL.—A controlled group of corporations shall (subject to the provisions of this section) have the privilege of electing to have each of its component members make its returns without regard to section 1561. Such election shall be made with respect to a specified December 31 and shall be valid only if—

"(A) each corporation which is a component member of such group on such December 31, and

"(B) each other corporation which is a component member of such group on any succeeding December 31 before the day on which the election is filed,

consents to such election.

"(2) YEARS FOR WHICH EFFECTIVE.—An election by a controlled group of corporations under paragraph (1) shall be effective with respect to the taxable year of each component member of such group which includes the specified December 31, and each taxable year of each corporation which is a component member of such group (or a successor group) on a succeeding December 31 included within such taxable year, unless the election is terminated under subsection (c).

"(3) EFFECT OF ELECTION.—If an election by a controlled group of corporations under paragraph (1) is effective with respect to any taxable year of a corporation—

"(A) section 1561 shall not apply to such corporation for such taxable year, but

"(B) the additional tax imposed by subsection (b) shall apply to such corporation for such taxable year.

"(b) ADDITIONAL TAX IMPOSED.—

"(1) GENERAL RULE.—If an election under subsection (a)(1) by a controlled group of corporations is effective with respect to the taxable year of a corporation, there is hereby imposed for such taxable year on the taxable income of such corporation a tax equal to 6 percent of so much of such corporation's taxable income for such taxable year as does not exceed $25,000. This paragraph shall not apply to the taxable year of a corporation if—

"(A) such corporation is the only component member of such controlled group on the December 31 included in such corporation's taxable year which has taxable income for a taxable year including such December 31, or

"(B) such corporation's surtax exemption is disallowed for such taxable year under any provision of this subtitle.

"(2) Tax treated as imposed by section 11, etc.—If for the taxable year of a corporation a tax is imposed by section 11 on the taxable income of such corporation, the additional tax imposed by this subsection shall be treated for purposes of this title as a tax imposed by section 11. If for the taxable year of a corporation a tax is imposed on the taxable income of such corporation which is computed under any other section by reference to section 11, the additional tax imposed by this subsection shall be treated for purposes of this title as imposed by such other section.

"(3) Taxable income defined.—For purposes of this subsection, the term 'taxable income' means—

"(A) in the case of a corporation subject to tax under section 511, its unrelated business taxable income (within the meaning of section 512);

"(B) in the case of a life insurance company, its life insurance company taxable income (within the meaning of section 802(b));

"(C) in the case of a regulated investment company, its investment company taxable income (within the meaning of section 852(b)(2)); and

"(D) in the case of a real estate investment trust, its real estate investment trust taxable income (within the meaning of section 857(b)(2)).

"(4) Special rules.—If for the taxable year an additional tax is imposed on the taxable income of a corporation by this subsection, then sections 244 (relating to dividends received on certain preferred stock), 247 (relating to dividends paid on certain preferred stock of public utilities), 804(a)(3) (relating to deduction for partially tax-exempt interest in the case of a life insurance company), and 922 (relating to special deduction for Western Hemisphere trade corporations) shall be applied without regard to the additional tax imposed by this subsection.

"(c) Termination of Election.—An election by a controlled group of corporations under subsection (a) shall terminate with respect to such group—

"(1) Consent of the members.—If such group files a termination of such election with respect to a specified December 31, and—

"(A) each corporation which is a component member of such group on such December 31, and

"(B) each other corporation which is a component member of such group on any succeeding December 31 before the day on which the termination is filed,

consents to such termination.

"(2) Refusal by new member to consent.—If on December 31 of any year such group includes a component member which—

"(A) on the immediately preceding January 1 was not a member of such group, and

"(B) within the time and in the manner provided by regulations prescribed by the Secretary or his delegate, files a statement that it does not consent to the election.

"(3) Consolidated returns.—If—

"(A) a corporation is a component member (determined without regard to section 1563(b)(3)) of such group on a December 31 included within a taxable year ending on or after January 1, 1964, and

"(B) such corporation is a member of an affiliated group of corporations which makes a consolidated return under this chapter (sec. 1501 and following) for such taxable year.

"(4) Controlled group no longer in existence.—If such group is considered as no longer in existence with respect to any December 31.

Such termination shall be effective with respect to the December 31 referred to in paragraph (1)(A), (2), (3), or (4), as the case may be.

"(d) Election After Termination.—If an election by a controlled group of corporations is terminated under subsection (c), such group (and any successor group) shall not be eligible to make an election under subsection (a) with

respect to any December 31 before the sixth December 31, after the December 31 with respect to which such termination was effective.

"(e) MANNER AND TIME OF GIVING CONSENT AND MAKING ELECTION, ETC.—An election under subsection (a)(1) or a termination under subsection (c)(1) (and the consent of each member of a controlled group of corporations which is required with respect to such election or termination) shall be made in such manner as the Secretary or his delegate shall by regulations prescribe, and shall be made at any time before the expiration of 3 years after—

"(1) in the case of such an election, the date when the income tax return for the taxable year of the component member of the controlled group which has the taxable year ending first on or after the specified December 31 is required to be filed (without regard to any extensions of time), and

"(2) in the case of such a termination, the specified December 31 with respect to which such termination was made.

Any consent to such an election or termination, and a failure by a component member to file a statement that it does not consent to an election under this section, shall be deemed to be a consent to the application of subsection (g)(1) (relating to tolling of statute of limitations on assessment of deficiencies).

"(f) SPECIAL RULES.—For purposes of this section—

"(1) CONTINUING AND SUCCESSOR CONTROLLED GROUPS.—The determination of whether a controlled group of corporations—

"(A) is considered as no longer in existence with respect to any December 31, or

"(B) is a successor to another controlled group of corporations (and the effect of such determination with respect to any election or termination),

shall be made under regulations prescribed by the Secretary or his delegate. For purposes of subparagraph (B), such regulations shall be based on the continuation (or termination) of predominant equitable ownership.

"(2) CERTAIN SHORT TAXABLE YEARS.—If one or more corporations have short taxable years which do not include a December 31 and are component members of a controlled group of corporations with respect to such taxable years (determined by applying section 1563(b) as if the last day of each such taxable year were substituted for December 31), then an election by such group under this section shall apply with respect to such corporations with respect to such taxable years if—

"(A) such election is in effect with respect to both the December 31 immediately preceding such taxable years and the December 31 immediately succeeding such taxable years, or

"(B) such election is in effect with respect to the December 31 immediately preceding or succeeding such taxable years and each such corporation files a consent to the application of such election to its short taxable year at such time and in such manner as the Secretary or his delegate shall prescribe by regulations.

"(g) TOLLING OF STATUTE OF LIMITATIONS.—In any case in which a controlled group of corporations makes an election or termination under this section, the statutory period—

"(1) for assessment of any deficiency against a corporation which is a component member of such group for any taxable year, to the extent such deficiency is attributable to the application of this part, shall not expire before the expiration of one year after the date such election or termination is made; and

"(2) for allowing or making credit or refund of any overpayment of tax by a corporation which is a component member of such group for any taxable year, to the extent such credit or refund is attributable to the application of this part, shall not expire before the expiration of one year after the date such election or termination is made.

"SEC. 1563. DEFINITIONS AND SPECIAL RULES.

"(a) CONTROLLED GROUP OF CORPORATIONS.—For purposes of this part, the term 'controlled group of corporations' means any group of—

"(1) PARENT-SUBSIDIARY CONTROLLED GROUP.—One or more chains of corporations connected through stock ownership with a common parent corporation if—

"(A) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corpora-

tions, except the common parent corporation, is owned (within the meaning of subsection (d) (1) by one or more of the other corporations; and

"(B) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

"(2) BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsection (d) (2) by one person who is an individual, estate, or trust.

"(3) COMBINED GROUP.—Three or more corporations each of which is a member of a group of corporations described in paragraph (1) or (2), and one of which—

"(A) is a common parent corporation included in a group of corporations described in paragraph (1), and also

"(B) is included in a group of corporations described in paragraph (2).

"(4) CERTAIN INSURANCE COMPANIES.—Two or more insurance companies subject to taxation under section 802 which are members of a controlled group of corporations described in paragraph (1), (2), or (3). Such insurance companies shall be treated as a controlled group of corporations separate from any other corporations which are members of the controlled group of corporations described in paragraph (1), (2), or (3).

"(b) COMPONENT MEMBER.—

"(1) GENERAL RULE.—For purposes of this part, a corporation is a component member of a controlled group of corporations on a December 31 of any taxable year (and with respect to the taxable year which includes such December 31) if such corporation—

"(A) is a member of such controlled group of corporations on the December 31 included in such year and is not treated as an excluded member under paragraph (2), or

"(B) is not a member of such controlled group of corporations on the December 31 included in such year but is treated as an additional member under paragraph (3).

"(2) EXCLUDED MEMBERS.—A corporation which is a member of a controlled group of corporations on December 31 of any taxable year shall be treated as an excluded member of such group for the taxable year including such December 31 if such corporation—

"(A) is a member of such group for less than one-half the number of days in such taxable year which precede such December 31,

"(B) is exempt from taxation under section 501(a) (except a corporation which is subject to tax on its unrelated business taxable income under section 511) for such taxable year.

"(C) is a foreign corporation subject to tax under section 881 for such taxable year,

"(D) is an insurance company subject to taxation under section 802 or section 821 (other than an insurance company which is a member of a controlled group described in subsection (a)(4)), or

"(E) is a franchised corporation, as defined in subsection (f)(4).

"(3) ADDITIONAL MEMBERS.—A corporation which—

"(A) was a member of a controlled group of corporations at any time during a calendar year,

"(B) is not a member of such group on December 31 of such calendar year, and

"(C) is not described, with respect to such group, in subparagraph (B), (C), (D), or (E) of paragraph (2),

shall be treated as an additional member of such group on December 31, for its taxable year including such December 31 if it was a member of such group for one-half (or more) of the number of days in such taxable year which precede such December 31.

"(4) OVERLAPPING GROUPS.—If a corporation is a component member of more than one controlled group of corporations with respect to any taxable year, such corporation shall be treated as a component member of only one controlled group. The determination as to the group of which such corporation is a component member shall be made under regulations prescribed by the Secretary or his delegate which are consistent with the purposes of this part.

"(c) CERTAIN STOCK EXCLUDED.—

"(1) GENERAL RULE.—For purposes of this part, the term 'stock' does not include—

"(A) nonvoting stock which is limited and preferred as to dividends,

"(B) treasury stock, and

"(C) stock which is treated as 'excluded stock' under paragraph (2).

"(2) STOCK TREATED AS 'EXCLUDED STOCK'.—

"(A) PARENT-SUBSIDIARY CONTROLLED GROUP.—For purposes of subsection (a)(1), if a corporation (referred to in this paragraph as 'parent corporation') owns (within the meaning of subsections (d)(1) and (e)(4)), 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in another corporation (referred to in this paragraph as 'subsidiary corporation'), the following stock of the subsidiary corporation shall be treated as excluded stock—

"(i) stock in the subsidiary corporation held by a trust which is part of a plan of deferred compensation for the benefit of the employees of the parent corporation or the subsidiary corporation,

"(ii) stock in the subsidiary corporation owned by an individual (within the meaning of subsection (d)(2)) who is a principal stockholder or officer of the parent corporation. For purposes of this clause, the term 'principal stockholder' of a corporation means an individual who owns (within the meaning of subsection (d)(2)) 5 percent or more of the total combined voting power of all classes of stock entitled to vote or 5 percent or more of the total value of shares of all classes of stock in such corporation, or

"(iii) stock in the subsidiary corporation owned (within the meaning of subsection (d)(2)) by an employee of the subsidiary corporation if such stock is subject to conditions which run in favor of such parent (or subsidiary) corporation and which substantially restrict or limit the employee's right (or if the employee constructively owns such stock, the direct owner's right) to dispose of such stock.

"(B) BROTHER-SISTER CONTROLLED GROUP.—For purposes of subsection (a)(2), if a person who is an individual, estate, or trust (referred to in this paragraph as 'common owner') owns (within the meaning of subsection (d)(2)), 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in a corporation, the following stock of such corporation shall be treated as excluded stock—

"(i) stock in such corporation held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if such trust is for the benefit of the employees of such corporation, or

"(ii) stock in such corporation owned (within the meaning of subsection (d)(2)) by an employee of the corporation if such stock is subject to conditions which run in favor of such common owner (or such corporation) and which substantially restrict or limit the employee's right (or if the employee constructively owns such stock, the direct owner's right) to dispose of such stock. If a condition which limits or restricts the employee's right (or the direct owner's right) to dispose of such stock also applies to the stock held by the common owner pursuant to a bona fide reciprocal stock purchase arrangement, such condition shall not be treated as one which restricts or limits the employee's right to dispose of such stock.

"(d) RULES FOR DETERMINING STOCK OWNERSHIP.—

"(1) PARENT-SUBSIDIARY CONTROLLED GROUP.—For purposes of determining whether a corporation is a member of a parent-subsidiary controlled

group of corporations (within the meaning of subsection (a)(1)), stock owned by a corporation means—

"(A) stock owned directly by such corporation, and

"(B) stock owned with the application of subsection (e)(1).

"(2) BROTHER-SISTER CONTROLLED GROUP.—For purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations (within the meaning of subsection (a)(2)), stock owned by a person who is an individual, estate, or trust means—

"(A) stock owned directly by such person, and

"(B) stock owned with the application of subsection (e).

"(e) CONSTRUCTIVE OWNERSHIP.—

"(1) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

"(2) ATTRIBUTION FROM PARTNERSHIPS.—Stock owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever such proportion is the greater.

"(3) ATTRIBUTION FROM ESTATES OR TRUSTS.—

"(A) Stock owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5 percent or more in such stock, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary.

"(B) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

"(C) This paragraph shall not apply to stock owned by any employees' trust described in section 401(a) which is exempt from tax under section 501(a).

"(4) ATTRIBUTION FROM CORPORATIONS.—Stock owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (within the meaning of subsection (d)) 5 percent or more in value of its stock in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

"(5) SPOUSE.—An individual shall be considered as owning stock in a corporation owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance), except in the case of a corporation with respect to which each of the following conditions is satisfied for its taxable year—

"(A) The individual does not, at any time during such taxable year, own directly any stock in such corporation;

"(B) The individual is not a director or employee and does not participate in the management of such corporation at any time during such taxable year;

"(C) Not more than 50 percent of such corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

"(D) Such stock in such corporation is not, at any time during such taxable year, subject to condtions which substantially restrict or limit the spouse's right to dispose of such stock and which run in favor of the individual or his children who have not attained the age of 21 years.

"(6) CHILDREN, GRANDCHILDREN, PARENTS, AND GRANDPARENTS.—

"(A) MINOR CHILDREN.—An individual shall be considered as owning stock owned, directly or indirectly, by or for his children who have not attained the age of 21 years, and, if the individual has not attained the age of 21 years, the stock owned, directly or indirectly, by or for his parents.

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"(B) ADULT CHILDREN AND GRANDCHILDREN.—An individual who owns (within the meaning of subsection (d)(2), but without regard to this subparagraph) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock in a corporation shall be considered as owning the stock in such corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren, and children who have attained the age of 21 years.

"(C) ADOPTED CHILD.—For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual by blood.

"(f) OTHER DEFINITIONS AND RULES.—

"(1) EMPLOYEE DEFINED.—For purposes of this section the term 'employee' has the same meaning such term is given in section 3306(i).

"(2) OPERATING RULES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), (4), (5), or (6) of subsection (e) shall, for purposes of applying such paragraphs, be treated as actually owned by such person.

"(B) MEMBERS OF FAMILY.—Stock constructively owned by an individual by reason of the application of paragraph (5) or (6) of subsection (e) shall not be treated as owned by him for purposes of again applying such paragraphs in order to make another the contructive owner of such stock.

"(3) SPECIAL RULES.—For purposes of this section—

"(A) If stock may be considered as owned by a person under subsection (e)(1) and under any other paragraph of subsection (e), it shall be considered as owned by him under subsection (e)(1).

"(B) If stock is owned (within the meaning of subsection (d)) by two or more persons, such stock shall be considered as owned by the person whose ownership of such stock results in the corporation being a component member of a controlled group. If by reason of the preceding sentence, a corporation would (but for this sentence) become a component member of two controlled groups, it shall be treated as a component member of one controlled group. The determination as to the group of which such corporation is a component member shall be made under regulations prescribed by the Secretary or his delegate which are consistent with the purposes of this part.

"(C) If stock is owned by a person within the meaning of subsection (d) and such ownership results in the corporation being a component member of a controlled group, such stock shall not be treated as excluded stock under subsection (c)(2), if by reason of treating such stock as excluded stock the result is that such corporation is not a component member of a controlled group of corporations.

"(4) FRANCHISED CORPORATION.—If—

"(A) a parent corporation (as defined in subsection (c)(2)(A)), or a common owner (as defined in subsection (c)(2)(B)), of a corporation which is a member of a controlled group of corporations is under a duty (arising out of a written agreement) to sell stock of such corporation (referred to in this paragraph as 'franchised corporation') which is franchised to sell the products of another member, or the common owner, of such controlled group;

"(B) such stock is to be sold to an employee (or employees) of such franchised corporation pursuant to a bona fide plan designed to eliminate the stock ownership of the parent corporation or of the common owner in the franchised corporation;

"(C) such plan—

"(i) provides a reasonable selling price for such stock, and

"(ii) requires that a portion of the employee's share of the profits of such corporation (whether received as compensation or as a dividend) be applied to the purchase of such stock (or the purchase of notes, bonds, debentures or other similar evidence of indebtedness of such franchised corporation held by such parent corporation or common owner);

"(D) such employee (or employees) owns directly more than 20 percent of the total value of shares of all classes of stock in such franchised corporation;

"(E) more than 50 percent of the inventory of such franchised corporation is acquired from members of the controlled group, the common owner, or both; and

"(F) all of the conditions contained in subparagraphs (A), (B), (C), (D), and (E) have been met for one-half (or more) of the number of days preceding the December 31 included within the taxable year (or if the taxable year does not include December 31, the last day of such year) of the franchised corporation,

then such franchised corporation shall be treated as an excluded member of such group, under subsection (b)(2), for such taxable year."

(b) Disallowance of Surtax Exemption and Accumulated Earnings Credit.—Section 1551 (relating to disallowance of surtax exemption and accumulated earnings credit) is amended to read as follows:

"SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.

"(a) In General.—If—

"(1) any corporation transfers, on or after January 1, 1951, and on or before June 12, 1963, all or part of its property (other than money) to a transferee corporation,

"(2) any corporation transfers, directly or indirectly, after June 12, 1963, all or part of its property (other than money) to a transferee corporation, or

"(3) five or fewer individuals who are in control of a corporation transfer, directly or indirectly, after June 12, 1963, property (other than money) to a transferee corporation,

and the transferee corporation was created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor or transferors are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then for such taxable year of such transferee corporation the Secretary or his delegate may (except as may be otherwise determined under subsection (d)) disallow the surtax exemption (as defined in section 11(d)), or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer.

"(b) Control.—For purposes of subsection (a), the term 'control' means—

"(1) With respect to a transferee corporation described in subsection (a)(1) or (2), the ownership by the transferor corporation, its shareholders, or both, of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock; or

"(2) With respect to each corporation described in subsection (a)(3), the ownership by the five or fewer individuals described in such subsection of stock possessing—

"(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

"(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.

For purposes of this subsection, section 1563(e) shall apply in determining the ownership of stock.

"(c) Authority of the Secretary Under This Section.—The provisions of section 269(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section."

(c) Technical Amendments.—

(1) Amendment of section 802.—The second sentence of section 802(a)(1) (relating to tax on life insurance companies) is amended to read as follows: "Such tax shall consist of a normal tax and surtax computed as

provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11."

(2) AMENDMENT OF SECTION 269.—Section 269(a) (relating to acquisitions made to evade or avoid income tax) is amended by striking out "then such deduction, credit, or other allowance shall not be allowed" at the end of the first sentence and inserting in lieu thereof "then the Secretary or his delegate may disallow such deduction, credit, or other allowance".

(3) SPECIAL RULE FOR 52–53-WEEK YEAR.—Section 441(f)(2)(A) (relating to effective date with respect to special rules for 52–53-week year) is amended by striking out "In any case in which the effective date or the applicability of any provision of this title is expressed in terms of taxable years beginning or ending with reference to a specified date" and inserting in lieu thereof "In any case in which the effective date or the applicability of any provision of this title is expressed in terms of taxable years beginning, including, or ending with reference to a specified date".

(4) Subchapter B of chapter 6 is amended by inserting after the heading and before the table of sections the following:

"Part I. In general.
"Part II. Certain controlled corporations.

"PART I—IN GENERAL"

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (c) shall apply with respect to taxable years ending after December 31, 1963. The amendment made by subsection (b) shall apply with respect to transfers made after June 12, 1963.

SEC. 236. VALIDITY OF TAX LIENS AGAINST PURCHASERS OF MOTOR VEHICLES.

(a) PURCHASERS WITHOUT ACTUAL NOTICE OR KNOWLEDGE OF LIEN.—Section 6323 (relating to validity of liens for Federal taxes) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) EXCEPTION IN CASE OF MOTOR VEHICLES.—

"(1) EXCEPTION.—Even though notice of a lien provided in section 6321 has been filed in the manner prescribed in subsection (a) of this section, the lien shall not be valid with respect to a motor vehicle, as defined in paragraph (2) of this subsection, as against any purchaser of such motor vehicle for an adequate and full consideration in money or money's worth if—

"(A) at the time of the purchase the purchaser is without notice or knowledge of the existence of such lien, and

"(B) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

"(2) DEFINITION OF MOTOR VEHICLE.—As used in this subsection, the term 'motor vehicle' means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country."

(b) LIENS FOR ESTATE AND GIFT TAXES.—Section 6324 (relating to special lien for estate and gift taxes) is amended by adding at the end thereof the following new subsection:

"(d) EXCEPTION IN CASE OF MOTOR VEHICLES.—The lien imposed by subsection (a) or (b) shall not be valid with respect to a motor vehicle, as defined in section 6323(d)(2), as against any purchaser of such motor vehicle for an adequate and full consideration in money or money's worth if—

"(1) at the time of the purchase the purchaser is without notice or knowledge of the existence of such lien, and

"(2) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent."

(c) CLERICAL AMENDMENTS.—

(1) Section 6323(a) is amended by striking out "subsection (c)" and inserting in lieu thereof "subsections (c) and (d)".

(2) Section 6324 is amended by inserting after "subsection (c) (relating to transfers of securities)" in subsections (a) and (b) the following: "and subsection (d) (relating to purchases of motor vehicles)".

(d) Effective Dates.—The amendments made by this section shall apply only with respect to purchases made after the date of the enactment of this Act.

SEC. 237. EXCLUSION OF EARNED INCOME OF CERTAIN UNITED STATES CITIZENS WHO ARE RESIDENTS OF FOREIGN COUNTRIES.

(a) Reduction of Limitation.—Subparagraph (B) of section 911(c)(1) (relating to limitations on amount of exclusion) is amended by striking out "$35,000" and inserting in lieu thereof "$25,000".

(b) Effective Date.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1964.

SEC. 238. LOSSES ARISING FROM CONFISCATION OF PROPERTY BY CUBA.

Section 165 (relating to losses) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) Certain Property Confiscated by Cuba.—For purposes of this chapter, any loss of tangible property, if such loss arises from expropriation, intervention, seizure, or similar taking by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, shall be treated as a loss from a casualty within the meaning of subsection (c)(3)."

SEC. 239. CREDIT OR REFUND OF SELF-EMPLOYMENT TAX.

Section 6511 (relating to limitations on credit or refund) is amended by adding at the end of subsection (d) the following new paragraph:

"(5) Special period of limitation with respect to self-employment tax in certain cases.—If the claim for credit or refund relates to an overpayment of the tax imposed by chapter 2 (relating to the tax on self-employment income) attributable to an agreement, or modification of an agreement, made pursuant to section 218 of the Social Security Act (relating to coverage of State and local employees), and if the allowance of a credit or refund of such overpayment is otherwise prevented by the operation of any law or rule of law other than section 7122 (relating to compromises), such credit or refund may be allowed or made if claim therefor is filed on or before the later of the following dates: (A) the last day of the second year after the calendar year in which such agreement (or modification) is agreed to by the State and the Secretary of Health, Education, and Welfare, or (B) December 31, 1965."

SEC. 240. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX ON VALUE OF REVERSIONARY OR REMAINDER INTEREST IN PROPERTY.

(a) Extension Under 1954 Code.—Section 6163(b) (relating to extension of time for paying estate tax on value of reversionary or remainder interest in property to prevent undue hardship) is amended by striking out "not in excess of 2" and inserting in lieu thereof "or periods not in excess of 3".

(b) Extension Under 1939 Code.—Section 925 of the Internal Revenue Code of 1939 (relating to periods of extension of time for paying estate tax attributable to future interests) is amended by striking out "not in excess of 2" and inserting in lieu thereof "or periods not in excess of 3".

(c) Effective Date.—

(1) The amendment made by subsection (a) shall apply in the case of any reversionary or remainder interest only if the time for payment of the tax under chapter 11 of the Internal Revenue Code of 1954 attributable to such interest, including any extensions thereof, has not expired on the date of the enactment of this Act.

(2) The amendment made by subsection (b) shall apply in the case of any reversionary or remainder interest only if the time for payment of the tax under chapter 3 of the Internal Revenue Code of 1939 attributable to such interest, including any extensions thereof, has not expired on the date of the enactment of this Act.

Title III—Optional Tax on Individuals; Collection of Income Tax at Source on Wages

SEC. 301. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000.

(a) Optional Tax.—Section 3 (relating to optional tax if adjusted gross income is less than $5,000) is amended to read as follows:

"SEC. 3. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000.

"(a) Taxable Years Beginning in 1964.—In lieu of the tax imposed by section 1, there is hereby imposed for each taxable year beginning on or after

January 1, 1964, and before January 1, 1965, on the taxable income of every individual whose adjusted gross income for such year is less than $5,000 and who has elected for such year to pay the tax imposed by this section, a tax as follows:

"Table I—Single Person—NOT Head of Household

"Taxable Years Beginning in 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—						
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7 or more
		The tax is—						The tax is—						
$0	$900	$0	$0	$0	$0	$2,450	$2,475	$261	$140	$26	$0	$0	$0	$0
900	925	2	0	0	0	2,475	2,500	266	144	30	0	0	0	0
925	950	6	0	0	0	2,500	2,525	270	148	34	0	0	0	0
950	975	10	0	0	0	2,525	2,550	275	152	38	0	0	0	0
975	1,000	14	0	0	0	2,550	2,575	279	156	42	0	0	0	0
1,000	1,025	18	0	0	0	2,575	2,600	284	160	46	0	0	0	0
1,025	1,050	22	0	0	0	2,600	2,625	288	165	50	0	0	0	0
1,050	1,075	26	0	0	0	2,625	2,650	293	169	54	0	0	0	0
1,075	1,100	30	0	0	0	2,650	2,675	297	173	58	0	0	0	0
1,100	1,125	34	0	0	0	2,675	2,700	302	178	62	0	0	0	0
1,125	1,150	38	0	0	0	2,700	2,725	306	182	66	0	0	0	0
1,150	1,175	42	0	0	0	2,725	2,750	311	187	70	0	0	0	0
1,175	1,200	46	0	0	0	2,750	2,775	315	191	74	0	0	0	0
1,200	1,225	50	0	0	0	2,775	2,800	320	195	78	0	0	0	0
1,225	1,250	54	0	0	0	2,800	2,825	324	200	82	0	0	0	0
1,250	1,275	58	0	0	0	2,825	2,850	329	204	86	0	0	0	0
1,275	1,300	62	0	0	0	2,850	2,875	333	208	90	0	0	0	0
1,300	1,325	66	0	0	0	2,875	2,900	338	213	94	0	0	0	0
1,325	1,350	70	0	0	0	2,900	2,925	343	217	99	0	0	0	0
1,350	1,375	74	0	0	0	2,925	2,950	348	222	103	0	0	0	0
1,375	1,400	78	0	0	0	2,950	2,975	353	226	107	0	0	0	0
1,400	1,425	82	0	0	0	2,975	3,000	358	230	111	0	0	0	0
1,425	1,450	86	0	0	0	3,000	3,050	365	237	117	4	0	0	0
1,450	1,475	90	0	0	0	3,050	3,100	374	246	125	12	0	0	0
1,475	1,500	94	0	0	0	3,100	3,150	383	255	134	20	0	0	0
1,500	1,525	99	0	0	0	3,150	3,200	392	264	142	28	0	0	0
1,525	1,550	103	0	0	0	3,200	3,250	401	273	150	36	0	0	0
1,550	1,575	107	0	0	0	3,250	3,300	410	282	158	44	0	0	0
1,575	1,600	111	0	0	0	3,300	3,350	419	291	167	52	0	0	0
1,600	1,625	115	2	0	0	3,350	3,400	428	300	176	60	0	0	0
1,625	1,650	119	6	0	0	3,400	3,450	437	309	184	68	0	0	0
1,650	1,675	123	10	0	0	3,450	3,500	446	318	193	76	0	0	0
1,675	1,700	127	14	0	0	3,500	3,550	455	327	202	84	0	0	0
1,700	1,725	132	18	0	0	3,550	3,600	464	336	211	92	0	0	0
1,725	1,750	136	22	0	0	3,600	3,650	473	345	219	101	0	0	0
1,750	1,775	140	26	0	0	3,650	3,700	482	355	228	109	0	0	0
1,775	1,800	144	30	0	0	3,700	3,750	491	365	237	117	4	0	0
1,800	1,825	148	34	0	0	3,750	3,800	500	375	246	125	12	0	0
1,825	1,850	152	38	0	0	3,800	3,850	509	385	255	134	20	0	0
1,850	1,875	156	42	0	0	3,850	3,900	518	395	264	142	28	0	0
1,875	1,900	160	46	0	0	3,900	3,950	527	405	273	150	36	0	0
1,900	1,925	165	50	0	0	3,950	4,000	536	415	282	158	44	0	0
1,925	1,950	169	54	0	0	4,000	4,050	545	425	291	167	52	0	0
1,950	1,975	173	58	0	0	4,050	4,100	554	434	300	176	60	0	0
1,975	2,000	178	62	0	0	4,100	4,150	563	443	309	184	68	0	0
2,000	2,025	182	66	0	0	4,150	4,200	572	452	318	193	76	0	0
2,025	2,050	187	70	0	0	4,200	4,250	581	461	327	202	84	0	0
2,050	2,075	191	74	0	0	4,250	4,300	590	470	336	211	92	0	0
2,075	2,100	195	78	0	0	4,300	4,350	599	479	345	219	101	0	0
2,100	2,125	200	82	0	0	4,350	4,400	608	488	355	228	109	0	0
2,125	2,150	204	86	0	0	4,400	4,450	617	497	365	237	117	4	0
2,150	2,175	208	90	0	0	4,450	4,500	626	506	375	246	125	12	0
2,175	2,200	213	94	0	0	4,500	4,550	635	515	385	255	134	20	0
2,200	2,225	217	99	0	0	4,550	4,600	644	524	395	264	142	28	0
2,225	2,250	222	103	0	0	4,600	4,650	653	533	405	273	150	36	0
2,250	2,275	226	107	0	0	4,650	4,700	662	542	415	282	158	44	0
2,275	2,300	230	111	0	0	4,700	4,750	671	551	425	291	167	52	0
2,300	2,325	235	115	2	0	4,750	4,800	680	560	435	300	176	60	0
2,325	2,350	239	119	6	0	4,800	4,850	689	569	445	309	184	68	0
2,350	2,375	243	123	10	0	4,850	4,900	698	578	455	318	193	76	0
2,375	2,400	248	127	14	0	4,900	4,950	707	587	465	327	202	84	0
2,400	2,425	252	132	18	0	4,950	5,000	716	596	475	336	211	92	0
2,425	2,450	257	136	22	0									

"Table II—Head of Household

"Taxable Years Beginning in 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—						
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7 or more
		The tax is—						The tax is—						
$0	$900	$0	$0	$0	$0	$2,450	$2,475	$258	$138	$26	$0	$0	$0	$0
900	925	2	0	0	0	2,475	2,500	263	142	30	0	0	0	0
925	950	6	0	0	0	2,500	2,525	267	146	34	0	0	0	0
950	975	10	0	0	0	2,525	2,550	272	150	38	0	0	0	0
975	1,000	14	0	0	0	2,550	2,575	276	154	42	0	0	0	0
1,000	1,025	18	0	0	0	2,575	2,600	280	158	46	0	0	0	0
1,025	1,050	22	0	0	0	2,600	2,625	285	162	50	0	0	0	0
1,050	1,075	26	0	0	0	2,625	2,650	289	167	54	0	0	0	0
1,075	1,100	30	0	0	0	2,650	2,675	293	171	58	0	0	0	0
1,100	1,125	34	0	0	0	2,675	2,700	298	175	62	0	0	0	0
1,125	1,150	38	0	0	0	2,700	2,725	302	180	66	0	0	0	0
1,150	1,175	42	0	0	0	2,725	2,750	307	184	70	0	0	0	0
1,175	1,200	46	0	0	0	2,750	2,775	311	188	74	0	0	0	0
1,200	1,225	50	0	0	0	2,775	2,800	315	193	78	0	0	0	0
1,225	1,250	54	0	0	0	2,800	2,825	320	197	82	0	0	0	0
1,250	1,275	58	0	0	0	2,825	2,850	324	202	86	0	0	0	0
1,275	1,300	62	0	0	0	2,850	2,875	328	206	90	0	0	0	0
1,300	1,325	66	0	0	0	2,875	2,900	333	210	94	0	0	0	0
1,325	1,350	70	0	0	0	2,900	2,925	337	215	98	0	0	0	0
1,350	1,375	74	0	0	0	2,925	2,950	342	219	102	0	0	0	0
1,375	1,400	78	0	0	0	2,950	2,975	347	223	106	0	0	0	0
1,400	1,425	82	0	0	0	2,975	3,000	352	228	110	0	0	0	0
1,425	1,450	86	0	0	0	3,000	3,050	358	234	116	4	0	0	0
1,450	1,475	90	0	0	0	3,050	3,100	367	243	124	12	0	0	0
1,475	1,500	94	0	0	0	3,100	3,150	375	252	132	20	0	0	0
1,500	1,525	98	0	0	0	3,150	3,200	384	261	140	28	0	0	0
1,525	1,550	102	0	0	0	3,200	3,250	392	269	148	36	0	0	0
1,550	1,575	106	0	0	0	3,250	3,300	401	278	156	44	0	0	0
1,575	1,600	110	0	0	0	3,300	3,350	410	287	164	52	0	0	0
1,600	1,625	114	2	0	0	3,350	3,400	418	296	173	60	0	0	0
1,625	1,650	118	6	0	0	3,400	3,450	427	304	182	68	0	0	0
1,650	1,675	122	10	0	0	3,450	3,500	435	313	191	76	0	0	0
1,675	1,700	126	14	0	0	3,500	3,550	444	322	199	84	0	0	0
1,700	1,725	130	18	0	0	3,550	3,600	452	331	208	92	0	0	0
1,725	1,750	134	22	0	0	3,600	3,650	461	340	217	100	0	0	0
1,750	1,775	138	26	0	0	3,650	3,700	469	349	226	108	0	0	0
1,775	1,800	142	30	0	0	3,700	3,750	478	359	234	116	4	0	0
1,800	1,825	146	34	0	0	3,750	3,800	487	368	243	124	12	0	0
1,825	1,850	150	38	0	0	3,800	3,850	495	378	252	132	20	0	0
1,850	1,875	154	42	0	0	3,850	3,900	504	387	261	140	28	0	0
1,875	1,900	158	46	0	0	3,900	3,950	512	397	269	148	36	0	0
1,900	1,925	162	50	0	0	3,950	4,000	521	406	278	156	44	0	0
1,925	1,950	167	54	0	0	4,000	4,050	529	415	287	164	52	0	0
1,950	1,975	171	58	0	0	4,050	4,100	538	424	296	173	60	0	0
1,975	2,000	175	62	0	0	4,100	4,150	546	432	304	182	68	0	0
2,000	2,025	180	66	0	0	4,150	4,200	555	441	313	191	76	0	0
2,025	2,050	184	70	0	0	4,200	4,250	563	449	322	199	84	0	0
2,050	2,075	188	74	0	0	4,250	4,300	572	458	331	208	92	0	0
2,075	2,100	193	78	0	0	4,300	4,350	581	467	340	217	100	0	0
2,100	2,125	197	82	0	0	4,350	4,400	589	475	349	226	108	0	0
2,125	2,150	202	86	0	0	4,400	4,450	598	484	359	234	116	4	0
2,150	2,175	206	90	0	0	4,450	4,500	606	492	368	243	124	12	0
2,175	2,200	210	94	0	0	4,500	4,550	615	501	378	252	132	20	0
2,200	2,225	215	98	0	0	4,550	4,600	623	509	387	261	140	28	0
2,225	2,250	219	102	0	0	4,600	4,650	632	518	397	269	148	36	0
2,250	2,275	223	106	0	0	4,650	4,700	640	526	406	278	156	44	0
2,275	2,300	228	110	0	0	4,700	4,750	649	535	416	287	164	52	0
2,300	2,325	232	114	2	0	4,750	4,800	658	544	425	296	173	60	0
2,325	2,350	237	118	6	0	4,800	4,850	666	552	435	304	182	68	0
2,350	2,375	241	122	10	0	4,850	4,900	675	561	444	313	191	76	0
2,375	2,400	245	126	14	0	4,900	4,950	683	569	454	322	199	84	0
2,400	2,425	250	130	18	0	4,950	5,000	692	578	463	331	208	92	0
2,425	2,450	254	134	22	0									

"Table III—Married Persons Filing JOINT Returns

"Taxable Years Beginning in 1964

If adjusted gross income is—		And the number of exemptions is—			If adjusted gross income is—		And the number of exemptions is—					
At least	But less than	2	3	4 or more	At least	But less than	2	3	4	5	6	7 or more
		The tax is—					The tax is—					
$0	$1,600	$0	$0	$0	$2,800	$2,825	$195	$82	$0	$0	$0	$0
1,600	1,625	2	0	0	2,825	2,850	199	86	0	0	0	0
1,625	1,650	6	0	0	2,850	2,875	203	90	0	0	0	0
1,650	1,675	10	0	0	2,875	2,900	207	94	0	0	0	0
1,675	1,700	14	0	0	2,900	2,925	212	98	0	0	0	0
1,700	1,725	18	0	0	2,925	2,950	216	102	0	0	0	0
1,725	1,750	22	0	0	2,950	2,975	220	106	0	0	0	0
1,750	1,775	26	0	0	2,975	3,000	224	110	0	0	0	0
1,775	1,800	30	0	0	3,000	3,050	230	116	4	0	0	0
1,800	1,825	34	0	0	3,050	3,100	238	124	12	0	0	0
1,825	1,850	38	0	0	3,100	3,150	247	132	20	0	0	0
1,850	1,875	42	0	0	3,150	3,200	255	140	28	0	0	0
1,875	1,900	46	0	0	3,200	3,250	263	148	36	0	0	0
1,900	1,925	50	0	0	3,250	3,300	271	156	44	0	0	0
1,925	1,950	54	0	0	3,300	3,350	280	164	52	0	0	0
1,950	1,975	58	0	0	3,350	3,400	288	172	60	0	0	0
1,975	2,000	62	0	0	3,400	3,450	296	181	68	0	0	0
2,000	2,025	66	0	0	3,450	3,500	304	189	76	0	0	0
2,025	2,050	70	0	0	3,500	3,550	313	197	84	0	0	0
2,050	2,075	74	0	0	3,550	3,600	321	205	92	0	0	0
2,075	2,100	78	0	0	3,600	3,650	329	214	100	0	0	0
2,100	2,125	82	0	0	3,650	3,700	338	222	108	0	0	0
2,125	2,150	86	0	0	3,700	3,750	347	230	116	4	0	0
2,150	2,175	90	0	0	3,750	3,800	356	238	124	12	0	0
2,175	2,200	94	0	0	3,800	3,850	364	247	132	20	0	0
2,200	2,225	98	0	0	3,850	3,900	373	255	140	28	0	0
2,225	2,250	102	0	0	3,900	3,950	382	263	148	36	0	0
2,250	2,275	106	0	0	3,950	4,000	391	271	156	44	0	0
2,275	2,300	110	0	0	4,000	4,050	399	280	164	52	0	0
2,300	2,325	114	2	0	4,050	4,100	407	288	172	60	0	0
2,325	2,350	118	6	0	4,100	4,150	415	296	181	68	0	0
2,350	2,375	122	10	0	4,150	4,200	423	304	189	76	0	0
2,375	2,400	126	14	0	4,200	4,250	430	313	197	84	0	0
2,400	2,425	130	18	0	4,250	4,300	438	321	205	92	0	0
2,425	2,450	134	22	0	4,300	4,350	446	329	214	100	0	0
2,450	2,475	138	26	0	4,350	4,400	454	338	222	108	0	0
2,475	2,500	142	30	0	4,400	4,450	462	347	230	116	4	0
2,500	2,525	146	34	0	4,450	4,500	470	356	238	124	12	0
2,525	2,550	150	38	0	4,500	4,550	478	364	247	132	20	0
2,550	2,575	154	42	0	4,550	4,600	486	373	255	140	28	0
2,575	2,600	158	46	0	4,600	4,650	493	382	263	148	36	0
2,600	2,625	162	50	0	4,650	4,700	501	391	271	156	44	0
2,625	2,650	166	54	0	4,700	4,750	509	399	280	164	52	0
2,650	2,675	170	58	0	4,750	4,800	518	408	288	172	60	0
2,675	2,700	174	62	0	4,800	4,850	526	417	296	181	68	0
2,700	2,725	179	66	0	4,850	4,900	534	426	304	189	76	0
2,725	2,750	183	70	0	4,900	4,950	542	434	313	197	84	0
2,750	2,775	187	74	0	4,950	5,000	550	443	321	205	92	0
2,775	2,800	191	78	0								

"Table IV—Married Persons Filing SEPARATE Returns

"10 PERCENT STANDARD DEDUCTION

"Taxable Years Beginning in 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—							
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7	8 or more
		The tax is—						The tax is—							
$0	$675	$0	$0	$0	$0	$2,325	$2,350	$251	$147	$49	$0	$0	$0	$0	$0
675	700	3	0	0	0	2,350	2,375	255	150	52	0	0	0	0	0
700	725	7	0	0	0	2,375	2,400	259	154	56	0	0	0	0	0
725	750	10	0	0	0	2,400	2,425	263	158	59	0	0	0	0	0
750	775	14	0	0	0	2,425	2,450	267	161	63	0	0	0	0	0
775	800	17	0	0	0	2,450	2,475	271	165	67	0	0	0	0	0
800	825	21	0	0	0	2,475	2,500	275	169	70	0	0	0	0	0
825	850	25	0	0	0	2,500	2,525	279	173	74	0	0	0	0	0
850	875	28	0	0	0	2,525	2,550	283	177	77	0	0	0	0	0
875	900	32	0	0	0	2,550	2,575	287	181	81	0	0	0	0	0
900	925	35	0	0	0	2,575	2,600	291	185	85	0	0	0	0	0
925	950	39	0	0	0	2,600	2,625	295	189	88	0	0	0	0	0
950	975	43	0	0	0	2,625	2,650	299	193	92	0	0	0	0	0
975	1,000	46	0	0	0	2,650	2,675	303	197	96	0	0	0	0	0
1,000	1,025	50	0	0	0	2,675	2,700	307	201	100	3	0	0	0	0
1,025	1,050	53	0	0	0	2,700	2,725	311	205	103	7	0	0	0	0
1,050	1,075	57	0	0	0	2,725	2,750	315	209	107	10	0	0	0	0
1,075	1,100	61	0	0	0	2,750	2,775	320	213	111	14	0	0	0	0
1,100	1,125	64	0	0	0	2,775	2,800	324	217	114	17	0	0	0	0
1,125	1,150	68	0	0	0	2,800	2,825	328	220	118	21	0	0	0	0
1,150	1,175	71	0	0	0	2,825	2,850	332	224	122	25	0	0	0	0
1,175	1,200	75	0	0	0	2,850	2,875	336	228	126	28	0	0	0	0
1,200	1,225	79	0	0	0	2,875	2,900	340	232	129	32	0	0	0	0
1,225	1,250	82	0	0	0	2,900	2,925	344	236	133	35	0	0	0	0
1,250	1,275	86	0	0	0	2,925	2,950	349	240	137	39	0	0	0	0
1,275	1,300	90			0	2,950	2,975	353	244	140	43	0	0	0	0
1,300	1,325	93	0	0	0	2,975	3,000	358	248	144	46	0	0	0	0
1,325	1,350	97	1	0	0	3,000	3,050	365	254	150	52	0	0	0	0
1,350	1,375	101	4	0	0	3,050	3,100	374	262	157	59	0	0	0	0
1,375	1,400	105	8	0	0	3,100	3,150	383	270	165	66	0	0	0	0
1,400	1,425	108	11	0	0	3,150	3,200	392	278	173	73	0	0	0	0
1,425	1,450	112	15	0	0	3,200	3,250	401	286	180	80	0	0	0	0
1,450	1,475	116	19	0	0	3,250	3,300	410	295	188	88	0	0	0	0
1,475	1,500	119	22	0	0	3,300	3,350	419	303	196	95	0	0	0	0
1,500	1,525	123	26	0	0	3,350	3,400	428	311	204	103	6	0	0	0
1,525	1,550	127	29	0	0	3,400	3,450	437	319	212	110	13	0	0	0
1,550	1,575	131	33	0	0	3,450	3,500	446	327	220	118	20	0	0	0
1,575	1,600	134	37	0	0	3,500	3,550	455	335	228	125	28	0	0	0
1,600	1,625	138	40	0	0	3,550	3,600	464	344	236	132	35	0	0	0
1,625	1,650	142	44	0	0	3,600	3,650	473	353	243	140	42	0	0	0
1,650	1,675	145	47	0	0	3,650	3,700	482	362	251	147	49	0	0	0
1,675	1,700	149	51	0	0	3,700	3,750	491	371	259	155	56	0	0	0
1,700	1,725	153	55	0	0	3,750	3,800	500	380	268	162	64	0	0	0
1,725	1,750	157	58	0	0	3,800	3,850	509	389	276	170	71	0	0	0
1,750	1,775	160	62	0	0	3,850	3,900	518	398	284	178	78	0	0	0
1,775	1,800	164	65	0	0	3,900	3,950	527	407	292	186	85	0	0	0
1,800	1,825	168	69	0	0	3,950	4,000	536	416	300	194	93	0	0	0
1,825	1,850	172	73	0	0	4,000	4,050	545	425	308	201	100	4	0	0
1,850	1,875	176	76	0	0	4,050	4,100	554	434	316	209	108	11	0	0
1,875	1,900	180	80	0	0	4,100	4,150	563	443	324	217	115	18	0	0
1,900	1,925	184	84	0	0	4,150	4,200	572	452	332	225	122	25	0	0
1,925	1,950	188	87	0	0	4,200	4,250	581	461	341	233	130	32	0	0
1,950	1,975	192	91	0	0	4,250	4,300	590	470	350	241	137	40	0	0
1,975	2,000	196	95	0	0	4,300	4,350	599	479	359	249	145	47	0	0
2,000	2,025	199	98	2	0	4,350	4,400	603	488	368	257	152	54	0	0
2,025	2,050	203	102	5	0	4,400	4,450	617	497	377	265	160	61	0	0
2,050	2,075	207	106	9	0	4,450	4,500	626	506	386	273	167	68	0	0
2,075	2,100	211	109	13	0	4,500	4,550	635	515	395	281	175	76	0	0
2,100	2,125	215	113	16	0	4,550	4,600	644	524	404	289	183	83	0	0
2,125	2,150	219	117	20	0	4,600	4,650	653	533	413	297	191	90	0	0
2,150	2,175	223	121	23	0	4,650	4,700	662	542	422	305	199	98	1	0
2,175	2,200	227	124	27	0	4,700	4,750	671	551	431	313	207	105	8	0
2,200	2,225	231	128	31	0	4,750	4,800	680	560	440	322	215	113	16	0
2,225	2,250	235	132	34	0	4,800	4,850	689	569	449	330	222	120	23	0
2,250	2,275	239	135	38	0	4,850	4,900	698	578	458	338	230	127	30	0
2,275	2,300	243	139	41	0	4,900	4,950	707	587	467	347	238	135	37	0
2,300	2,325	247	143	45	0	4,950	5,000	716	596	476	356	246	142	44	0

"Table V—Married Persons Filing SEPARATE Returns

"MINIMUM STANDARD DEDUCTION

"Taxable Years Beginning in 1964

If adjusted gross income is—		And the number of exemptions is—			
At least	But less than	1	2	3	4 or more
		The tax is—			
$0	$800	$0	$0	$0	$0
800	825	2	0	0	0
825	850	6	0	0	0
850	875	10	0	0	0
875	900	14	0	0	0
900	925	18	0	0	0
925	950	22	0	0	0
950	975	26	0	0	0
975	1,000	30	0	0	0
1,000	1,025	34	0	0	0
1,025	1,050	38	0	0	0
1,050	1,075	42	0	0	0
1,075	1,100	46	0	0	0
1,100	1,125	50	0	0	0
1,125	1,150	54	0	0	0
1,150	1,175	58	0	0	0
1,175	1,200	62	0	0	0
1,200	1,225	66	0	0	0
1,225	1,250	70	0	0	0
1,250	1,275	74	0	0	0
1,275	1,300	78	0	0	0
1,300	1,325	82	0	0	0
1,325	1,350	86	0	0	0
1,350	1,375	90	0	0	0
1,375	1,400	94	0	0	0
1.400	1,425	99	0	0	0
1,425	1,450	103	0	0	0
1,450	1,475	107	0	0	0
1,475	1,500	111	0	0	0
1,500	1,525	115	2	0	0
1,525	1,550	119	6	0	0
1,550	1,575	123	10	0	0
1,575	1,600	127	14	0	0
1,600	1,625	132	18	0	0
1,625	1,650	136	22	0	0
1,650	1,675	140	26	0	0
1,675	1,700	144	30	0	0
1,700	1,725	148	34	0	0
1,725	1,750	152	38	0	0
1,750	1,775	156	42	0	0
1,775	1,800	160	46	0	0
1,800	1,825	165	50	0	0
1,825	1,850	169	54	0	0
1,850	1,875	173	58	0	0
1,875	1,900	178	62	0	0
1,900	1.925	182	66	0	0
1,925	1,950	187	70	0	0
1,950	1,975	191	74	0	0
1,975	2,000	195	78	0	0
2,000	2,025	200	82	0	0
2,025	2,050	204	86	0	0
2,050	2,075	208	90	0	0
2,075	2,100	213	94	0	0
2,100	2,125	217	99	0	0
2,125	2,150	222	103	0	0
2,150	2,175	226	107	0	0
2,175	2,200	230	111	0	0
2,200	2,225	235	115	2	0
2,225	2,250	239	119	6	0
2,250	2,275	243	123	10	0
2,275	2,300	248	127	14	0
2,300	2.325	252	132	18	0
2,325	2,350	257	136	22	0
2,350	2,375	261	140	26	0
2,375	2,400	266	144	30	0

If adjusted gross income is—		And the number of exemptions is—							
At least	But less than	1	2	3	4	5	6	7	8 or more
		The tax is—							
$2,400	$2,425	$270	$148	$34	$0	$0	$0	$0	$0
2,425	2,450	275	152	38	0	0	0	0	0
2,450	2,475	279	156	42	0	0	0	0	0
2,475	2,500	284	160	46	0	0	0	0	0
2,500	2,525	288	165	50	0	0	0	0	0
2,525	2.550	293	169	54	0	0	0	0	0
2,550	2,575	297	173	58	0	0	0	0	0
2,575	2,600	302	178	62	0	0	0	0	0
2.600	2,625	306	182	66	0	0	0	0	0
2,625	2,650	311	187	70	0	0	0	0	0
2,650	2,675	315	191	74	0	0	0	0	0
2,675	2,700	320	195	78	0	0	0	0	0
2,700	2,725	324	200	82	0	0	0	0	0
2,725	2.750	329	204	86	0	0	0	0	0
2,750	2,775	333	208	90	0	0	0	0	0
2,775	2,800	338	213	94	0	0	0	0	0
2,800	2,825	343	217	99	0	0	0	0	0
2,825	2,850	348	222	103	0	0	0	0	0
2,850	2,875	353	226	107	0	0	0	0	0
2,875	2,900	358	230	111	0	0	0	0	0
2,900	2,925	363	235	115	2	0	0	0	0
2,925	2,950	368	239	119	6	0	0	0	0
2,950	2,975	373	243	123	10	0	0	0	0
2,975	3,000	378	248	127	14	0	0	0	0
3.000	3.050	385	255	134	20	0	0	0	0
3.050	3.100	395	264	142	28	0	0	0	0
3,100	3,150	405	273	150	36	0	0	0	0
3,150	3.200	415	282	158	44	0	0	0	0
3,200	3,250	425	291	167	52	0	0	0	0
3.250	3,300	435	300	176	60	0	0	0	0
3,300	3,350	445	309	184	68	0	0	0	0
3.350	3,400	455	318	193	76	0	0	0	0
3,400	3,450	465	327	202	84	0	0	0	0
3,450	3.500	475	336	211	92	0	0	0	0
3,500	3,550	485	345	219	101	4	0	0	0
3,550	3,600	495	355	228	109	12	0	0	0
3,600	3,650	505	365	237	117	20	0	0	0
3,650	3,700	515	375	246	125	28	0	0	0
3,700	3,750	525	385	255	134	36	0	0	0
3,750	3,800	535	395	264	142	44	0	0	0
3,800	3,850	545	405	273	150	52	0	0	0
3,850	3,900	555	415	282	158	60	0	0	0
3,900	3,950	565	425	291	167	68	0	0	0
3,950	4,000	575	435	300	176	76	0	0	0
4,000	4,050	585	445	309	184	84	0	0	0
4,050	4,100	595	455	318	193	92	0	0	0
4,100	4,150	605	465	327	202	101	4	0	0
4,150	4,200	615	475	336	211	109	12	0	0
4,200	4,250	625	485	345	219	117	20	0	0
4,250	4,300	635	495	355	228	125	28	0	0
4,300	4,350	645	505	365	237	134	36	0	0
4,350	4,400	655	515	375	246	142	44	0	0
4,400	4,450	665	525	385	255	150	52	0	0
4,450	4.500	675	535	395	264	158	60	0	0
4,500	4,550	685	545	405	273	167	68	0	0
4,550	4,600	695	555	415	282	176	76	0	0
4,600	4,650	705	565	425	291	184	84	0	0
4,650	4,700	715	575	435	300	193	92	0	0
4,700	4,750	725	585	445	309	202	101	4	0
4,750	4,800	735	595	455	318	211	109	12	0
4.800	4,850	746	605	465	327	219	117	20	0
4,850	4,900	758	615	475	336	228	125	28	0
4,900	4,950	769	625	485	345	237	134	36	0
4,950	5,000	781	635	495	355	246	142	44	0

"(b) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1964.—In lieu of the tax imposed by section 1, there is hereby imposed for each taxable year beginning after December 31, 1964, on the taxable income of every individual whose adjusted gross income for such year is less than $5,000 and who has elected for such year to pay the tax imposed by this section a tax as follows:

"Table I—Single Person—NOT Head of Household

"Taxable Years Beginning After December 31, 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—						
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7 or more
		The tax is—						The tax is—						
$0	$900	$0	$0	$0	$0	$2,450	$2,475	$236	$124	$23	$0	$0	$0	$0
900	925	2	0	0	0	2,475	2,500	240	128	26	0	0	0	0
925	950	5	0	0	0	2,500	2,525	244	132	30	0	0	0	0
950	975	9	0	0	0	2,525	2,550	248	136	33	0	0	0	0
975	1,000	12	0	0	0	2,550	2,575	253	139	37	0	0	0	0
1,000	1,025	16	0	0	0	2,575	2,600	257	143	40	0	0	0	0
1,025	1,050	19	0	0	0	2,600	2,625	261	147	44	0	0	0	0
1,050	1,075	23	0	0	0	2,625	2,650	265	151	47	0	0	0	0
1,075	1,100	26	0	0	0	2,650	2,675	270	155	51	0	0	0	0
1,100	1,125	30	0	0	0	2,675	2,700	274	159	54	0	0	0	0
1,125	1,150	33	0	0	0	2,700	2,725	278	163	58	0	0	0	0
1,150	1,175	37	0	0	0	2,725	2,750	282	167	61	0	0	0	0
1,175	1,200	40	0	0	0	2,750	2,775	287	171	65	0	0	0	0
1,200	1,225	44	0	0	0	2,775	2,800	291	175	68	0	0	0	0
1,225	1,250	47	0	0	0	2,800	2,825	295	179	72	0	0	0	0
1,250	1,275	51	0	0	0	2,825	2,850	299	183	76	0	0	0	0
1,275	1,300	54	0	0	0	2,850	2,875	304	187	79	0	0	0	0
1,300	1,325	58	0	0	0	2,875	2,900	308	191	83	0	0	0	0
1,325	1,350	61	0	0	0	2,900	2,925	312	195	87	0	0	0	0
1,350	1,375	65	0	0	0	2,925	2,950	317	199	91	0	0	0	0
1,375	1,400	68	0	0	0	2,950	2,975	322	203	94	0	0	0	0
1,400	1,425	72	0	0	0	2,975	3,000	327	207	98	0	0	0	0
1,425	1,450	76	0	0	0	3,000	3,050	333	213	104	4	0	0	0
1,450	1,475	79	0	0	0	3,050	3,100	342	221	111	11	0	0	0
1,475	1,500	83	0	0	0	3,100	3,150	350	229	119	18	0	0	0
1,500	1,525	87	0	0	0	3,150	3,200	359	238	126	25	0	0	0
1,525	1,550	91	0	0	0	3,200	3,250	367	246	134	32	0	0	0
1,550	1,575	94	0	0	0	3,250	3,300	376	255	141	39	0	0	0
1,575	1,600	98	0	0	0	3,300	3,350	385	263	149	46	0	0	0
1,600	1,625	102	2	0	0	3,350	3,400	393	272	157	53	0	0	0
1,625	1,650	106	5	0	0	3,400	3,450	402	280	165	60	0	0	0
1,650	1,675	109	9	0	0	3,450	3,500	410	289	173	67	0	0	0
1,675	1,700	113	12	0	0	3,500	3,550	419	297	181	74	0	0	0
1,700	1,725	117	16	0	0	3,550	3,600	427	306	189	81	0	0	0
1,725	1,750	121	19	0	0	3,600	3,650	436	315	197	89	0	0	0
1,750	1,775	124	23	0	0	3,650	3,700	444	324	205	96	0	0	0
1,775	1,800	128	26	0	0	3,700	3,750	453	334	213	104	4	0	0
1,800	1,825	132	30	0	0	3,750	3,800	462	343	221	111	11	0	0
1,825	1,850	136	33	0	0	3,800	3,850	470	353	229	119	18	0	0
1,850	1,875	139	37	0	0	3,850	3,900	479	362	238	126	25	0	0
1,875	1,900	143	40	0	0	3,900	3,950	487	372	246	134	32	0	0
1,900	1,925	147	44	0	0	3,950	4,000	496	381	255	141	39	0	0
1,925	1,950	151	47	0	0	4,000	4,050	504	390	263	149	46	0	0
1,950	1,975	155	51	0	0	4,050	4,100	513	399	272	157	53	0	0
1,975	2,000	159	54	0	0	4,100	4,150	521	407	280	165	60	0	0
2,000	2,025	163	58	0	0	4,150	4,200	530	416	289	173	67	0	0
2,025	2,050	167	61	0	0	4,200	4,250	538	424	297	181	74	0	0
2,050	2,075	171	65	0	0	4,250	4,300	547	433	306	189	81	0	0
2,075	2,100	175	68	0	0	4,300	4,350	556	442	315	197	89	0	0
2,100	2,125	179	72	0	0	4,350	4,400	564	450	324	205	96	0	0
2,125	2,150	183	76	0	0	4,400	4,450	573	459	334	213	104	4	0
2,150	2,175	187	79	0	0	4,450	4,500	581	467	343	221	111	11	0
2,175	2,200	191	83	0	0	4,500	4,550	590	476	353	229	119	18	0
2,200	2,225	195	87	0	0	4,550	4,600	598	484	362	238	126	25	0
2,225	2,250	199	91	0	0	4,600	4,650	607	493	372	246	134	32	0
2,250	2,275	203	94	0	0	4,650	4,700	615	501	381	255	141	39	0
2,275	2,300	207	98	0	0	4,700	4,750	624	510	391	263	149	46	0
2,300	2,325	211	102	2	0	4,750	4,800	633	519	400	272	157	53	0
2,325	2,350	215	106	5	0	4,800	4,850	641	527	410	280	165	60	0
2,350	2,375	219	109	9	0	4,850	4,900	650	536	419	289	173	67	0
2,375	2,400	223	113	12	0	4,900	4,950	658	544	429	297	181	74	0
2,400	2,425	227	117	16	0	4,950	5,000	667	553	438	306	189	81	0
2,425	2,450	231	121	19	0									

"Table II—Head of Household

"Taxable Years Beginning After December 31, 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—						
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7 or more
		The tax is—						The tax is—						
$0	$900	$0	$0	$0	$0	$2,450	$2,475	$230	$121	$23	$0	$0	$0	$0
900	925	2	0	0	0	2,475	2,500	234	124	26	0	0	0	0
925	950	5	0	0	0	2,500	2,525	238	128	30	0	0	0	0
950	975	9	0	0	0	2,525	2,550	242	131	33	0	0	0	0
975	1,000	12	0	0	0	2,550	2,575	246	135	37	0	0	0	0
1,000	1,025	16	0	0	0	2,575	2,600	250	138	40	0	0	0	0
1,025	1,050	19	0	0	0	2,600	2,625	254	142	44	0	0	0	0
1,050	1,075	23	0	0	0	2,625	2,650	258	146	47	0	0	0	0
1,075	1,100	26	0	0	0	2,650	2,675	262	150	51	0	0	0	0
1,100	1,125	30	0	0	0	2,675	2,700	266	154	54	0	0	0	0
1,125	1,150	33	0	0	0	2,700	2,725	270	158	58	0	0	0	0
1,150	1,175	37	0	0	0	2,725	2.750	274	162	61	0	0	0	0
1,175	1,200	40	0	0	0	2,750	2,775	278	166	65	0	0	0	0
1,200	1,225	44	0	0	0	2,775	2,800	282	170	68	0	0	0	0
1,225	1,250	47	0	0	0	2,800	2,825	286	174	72	0	0	0	0
1,250	1,275	51	0	0	0	2,825	2,850	290	178	75	0	0	0	0
1,275	1,300	54	0	0	0	2,850	2,875	294	182	79	0	0	0	0
1,300	1,325	58	0	0	0	2.875	2,900	298	186	82	0	0	0	0
1,325	1,350	61	0	0	0	2,900	2,925	302	190	86	0	0	0	0
1,350	1,375	65	0	0	0	2,925	2,950	307	194	89	0	0	0	0
1,375	1,400	68	0	0	0	2,950	2,975	311	198	93	0	0	0	0
1,400	1,425	72	0	0	0	2,975	3,000	316	202	96	0	0	0	0
1,425	1,450	75	0	0	0	3,000	3,050	322	208	102	4	0	0	0
1,450	1,475	79	0	0	0	3,050	3,100	330	216	109	11	0	0	0
1,475	1,500	82	0	0	0	3,100	3,150	338	224	116	18	0	0	0
1,500	1,525	86	0	0	0	3,150	3,200	346	232	123	25	0	0	0
1,525	1,550	89	0	0	0	3,200	3,250	354	240	130	32	0	0	0
1,550	1,575	93	0	0	0	3,250	3,300	363	248	137	39	0	0	0
1,575	1,600	96	0	0	0	3,300	3,350	371	256	144	46	0	0	0
1,600	1,625	100	2	0	0	3,350	3,400	379	264	152	53	0	0	0
1,625	1,650	103	5	0	0	3,400	3,450	387	272	160	60	0	0	0
1,650	1,675	107	9	0	0	3,450	3,500	395	280	168	67	0	0	0
1,675	1,700	110	12	0	0	3.500	3,550	403	288	176	74	0	0	0
1,700	1,725	114	16	0	0	3,550	3,600	411	296	184	81	0	0	0
1,725	1,750	117	19	0	0	3,600	3,650	419	305	192	88	0	0	0
1,750	1,775	121	23	0	0	3,650	3,700	427	314	200	95	0	0	0
1,775	1,800	124	26	0	0	3,700	3,750	435	323	208	102	4	0	0
1,800	1,825	128	30	0	0	3,750	3,800	444	332	216	109	11	0	0
1,825	1,850	131	33	0	0	3,800	3,850	452	341	224	116	18	0	0
1,850	1,875	135	37	0	0	3,850	3,900	460	350	232	123	25	0	0
1,875	1,900	138	40	0	0	3,900	3,950	468	359	240	130	32	0	0
1,900	1,925	142	44	0	0	3,950	4,000	476	368	248	137	39	0	0
1,925	1,950	146	47	0	0	4,000	4,050	484	376	256	144	46	0	0
1,950	1,975	150	51	0	0	4,050	4,100	492	384	264	152	53	0	0
1,975	2,000	154	54	0	0	4,100	4,150	500	392	272	160	60	0	0
2,000	2,025	158	58	0	0	4,150	4,200	508	400	280	168	67	0	0
2,025	2,050	162	61	0	0	4,200	4,250	516	408	288	176	74	0	0
2,050	2,075	166	65	0	0	4.250	4,300	525	417	296	184	81	0	0
2,075	2,100	170	68	0	0	4,300	4,350	533	425	305	192	88	0	0
2,100	2,125	174	72	0	0	4.350	4,400	541	433	314	200	95	0	0
2,125	2,150	178	75	0	0	4,400	4,450	549	441	323	208	102	4	0
2,150	2,175	182	79	0	0	4,450	4,500	557	449	332	216	109	11	0
2,175	2.200	186	82	0	0	4,500	4,550	565	457	341	224	116	18	0
2.200	2,225	190	86	0	0	4,550	4,600	573	465	350	232	123	25	0
2,225	2,250	194	89	0	0	4,600	4,650	581	473	359	240	130	32	0
2,250	2,275	198	93	0	0	4,650	4,700	589	481	368	248	137	39	0
2,275	2,300	202	96	0	0	4,700	4,750	597	489	377	256	144	46	0
2,300	2,325	206	100	2	0	4,750	4,800	606	498	386	264	152	53	0
2,325	2,350	210	103	5	0	4,800	4,850	614	506	395	272	160	60	0
2,350	2,375	214	107	9	0	4,850	4,900	622	514	404	280	168	67	0
2,375	2.400	218	110	12	0	4,900	4,950	630	522	413	288	176	74	0
2,400	2.425	222	114	16	0	4,950	5,000	638	530	422	296	184	81	0
2.425	2,450	226	117	19	0									

"Table III—Married Persons Filing JOINT Returns

"Taxable Years Beginning After December 31, 1964

If adjusted gross income is—		And the number of exemptions is—			If adjusted gross income is—		And the number of exemptions is—					
At least	But less than	2	3	4 or more	At least	But less than	2	3	4	5	6	7 or more
		The tax is—					The tax is—					
$0	$1,600	$0	$0	$0	$2,800	$2,825	$172	$72	$0	$0	$0	$0
1,600	1,625	2	0	0	2,825	2,850	176	75	0	0	0	0
1,625	1,650	5	0	0	2,850	2,875	179	79	0	0	0	0
1,650	1,675	9	0	0	2,875	2,900	183	82	0	0	0	0
1,675	1,700	12	0	0	2,900	2,925	187	86	0	0	0	0
1,700	1,725	16	0	0	2,925	2,950	191	89	0	0	0	0
1,725	1,750	19	0	0	2,950	2,975	194	93	0	0	0	0
1,750	1,775	23	0	0	2,975	3,000	198	96	0	0	0	0
1,775	1,800	26	0	0	3,000	3,050	204	102	4	0	0	0
1,800	1,825	30	0	0	3,050	3,100	211	109	11	0	0	0
1,825	1,850	33	0	0	3,100	3,150	219	116	18	0	0	0
1,850	1,875	37	0	0	3,150	3,200	226	123	25	0	0	0
1,875	1,900	40	0	0	3,200	3,250	234	130	32	0	0	0
1,900	1,925	44	0	0	3,250	3,300	241	137	39	0	0	0
1,925	1,950	47	0	0	3,300	3,350	249	144	46	0	0	0
1,950	1,975	51	0	0	3,350	3,400	256	151	53	0	0	0
1,975	2,000	54	0	0	3,400	3,450	264	159	60	0	0	0
2,000	2,025	58	0	0	3,450	3,500	271	166	67	0	0	0
2,025	2,050	61	0	0	3,500	3,550	279	174	74	0	0	0
2,050	2,075	65	0	0	3,550	3,600	286	181	81	0	0	0
2,075	2,100	68	0	0	3,600	3,650	294	189	88	0	0	0
2,100	2,125	72	0	0	3,650	3,700	302	196	95	0	0	0
2,125	2,150	75	0	0	3,700	3,750	310	204	102	4	0	0
2,150	2,175	79	0	0	3,750	3,800	318	211	109	11	0	0
2,175	2,200	82	0	0	3,800	3,850	326	219	116	18	0	0
2,200	2,225	86	0	0	3,850	3,900	334	226	123	25	0	0
2,225	2,250	89	0	0	3,900	3,950	342	234	130	32	0	0
2,250	2,275	93	0	0	3,950	4,000	350	241	137	39	0	0
2,275	2,300	96	0	0	4,000	4,050	358	249	144	46	0	0
2,300	2,325	100	2	0	4,050	4,100	365	256	151	53	0	0
2,325	2,350	103	5	0	4,100	4,150	372	264	159	60	0	0
2,350	2,375	107	9	0	4,150	4,200	379	271	166	67	0	0
2,375	2,400	110	12	0	4,200	4,250	386	279	174	74	0	0
2,400	2,425	114	16	0	4,250	4,300	394	286	181	81	0	0
2,425	2,450	117	19	0	4,300	4,350	401	294	189	88	0	0
2,450	2,475	121	23	0	4,350	4,400	408	302	196	95	0	0
2,475	2,500	124	26	0	4,400	4,450	415	310	204	102	4	0
2,500	2,525	128	30	0	4,450	4,500	422	318	211	109	11	0
2,525	2,550	131	33	0	4,500	4,550	430	326	219	116	18	0
2,550	2,575	135	37	0	4,550	4,600	437	334	226	123	25	0
2,575	2,600	138	40	0	4,600	4,650	444	342	234	130	32	0
2,600	2,625	142	44	0	4,650	4,700	451	350	241	137	39	0
2,625	2,650	146	47	0	4,700	4,750	459	358	249	144	46	0
2,650	2,675	149	51	0	4,750	4,800	467	366	256	151	53	0
2,675	2,700	153	54	0	4,800	4,850	474	374	264	159	60	0
2,700	2,725	157	58	0	4,850	4,900	482	382	271	166	67	0
2,725	2,750	161	61	0	4,900	4,950	490	390	279	174	74	0
2,750	2,775	164	65	0	4,950	5,000	497	398	286	181	81	0
2,775	2,800	168	68	0								

"Table IV—Married Persons Filing SEPARATE Returns

"10 PERCENT STANDARD DEDUCTION

"Taxable Years Beginning After December 31, 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—							
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7	8 or more
		The tax is—						The tax is—							
$0	$675	$0	$0	$0	$0	$2,325	$2,350	$226	$131	$43	$0	$0	$0	$0	$0
675	700	3	0	0	0	2,350	2,375	229	134	46	0	0	0	0	0
700	725	6	0	0	0	2,375	2,400	233	137	49	0	0	0	0	0
725	750	9	0	0	0	2,400	2,425	237	141	52	0	0	0	0	0
750	775	12	0	0	0	2,425	2,450	241	144	55	0	0	0	0	0
775	800	15	0	0	0	2,450	2,475	245	148	58	0	0	0	0	0
800	825	18	0	0	0	2,475	2,500	249	151	61	0	0	0	0	0
825	850	22	0	0	0	2,500	2,525	252	155	65	0	0	0	0	0
850	875	25	0	0	0	2,525	2,550	256	158	68	0	0	0	0	0
875	900	28	0	0	0	2,550	2,575	260	162	74	0	0	0	0	0
900	925	31	0	0	0	2,575	2,600	264	166	71	0	0	0	0	0
925	950	34	0	0	0	2,600	2,625	268	169	78	0	0	0	0	0
950	975	37	0	0	0	2,625	2,650	272	173	81	0	0	0	0	0
975	1,000	40	0	0	0	2,650	2,675	275	176	84	0	0	0	0	0
1,000	1,025	44	0	0	0	2,675	2,700	279	180	88	3	0	0	0	0
1,025	1,050	47	0	0	0	2,700	2,725	283	184	91	6	0	0	0	0
1,050	1,075	50	0	0	0	2,725	2,750	287	187	95	9	0	0	0	0
1,075	1,100	53	0	0	0	2,750	2,775	291	191	98	12	0	0	0	0
1,100	1,125	56	0	0	0	2,775	2,800	294	194	101	15	0	0	0	0
1,125	1,150	59	0	0	0	2,800	2,825	298	198	105	18	0	0	0	0
1,150	1,175	62	0	0	0	2,825	2,850	302	202	108	22	0	0	0	0
1,175	1,200	66	0	0	0	2,850	2,875	306	205	111	25	0	0	0	0
1,200	1,225	69	0	0	0	2,875	2,900	310	209	115	28	0	0	0	0
1,225	1,250	72	0	0	0	2,900	2,925	314	212	118	31	0	0	0	0
1,250	1,275	75	0	0	0	2,925	2,950	318	216	122	34	0	0	0	0
1,275	1,300	79	0	0	0	2,950	2,975	323	220	125	37	0	0	0	0
1,300	1,325	82	0	0	0	2,975	3,000	327	223	128	40	0	0	0	0
1,325	1,350	86	1	0	0	3,000	3,050	333	229	133	45	0	0	0	0
1,350	1,375	89	4	0	0	3,050	3,100	342	236	140	51	0	0	0	0
1,375	1,400	92	7	0	0	3,100	3,150	350	244	147	58	0	0	0	0
1,400	1,425	96	10	0	0	3,150	3,200	359	252	154	64	0	0	0	0
1,425	1,450	99	13	0	0	3,200	3,250	367	259	161	70	0	0	0	0
1,450	1,475	102	16	0	0	3,250	3,300	376	267	169	77	0	0	0	0
1,475	1,500	106	19	0	0	3,300	3,350	385	275	176	84	0	0	0	0
1,500	1,525	109	23	0	0	3,350	3,400	393	282	183	91	5	0	0	0
1,525	1,550	113	26	0	0	3,400	3,450	402	290	190	97	12	0	0	0
1,550	1,575	116	29	0	0	3,450	3,500	410	298	197	104	18	0	0	0
1,575	1,600	119	32	0	0	3,500	3,550	419	305	205	111	24	0	0	0
1,600	1,625	123	35	0	0	3,550	3,600	427	313	212	118	30	0	0	0
1,625	1,650	126	38	0	0	3,600	3,650	436	322	219	124	37	0	0	0
1,650	1,675	129	41	0	0	3,650	3,700	444	330	226	131	43	0	0	0
1,675	1,700	133	45	0	0	3,700	3,750	453	339	234	138	49	0	0	0
1,700	1,725	136	48	0	0	3,750	3,800	462	348	242	145	56	0	0	0
1,725	1,750	140	51	0	0	3,800	3,850	470	356	249	152	62	0	0	0
1,750	1,775	143	54	0	0	3,850	3,900	479	365	257	159	68	0	0	0
1,775	1,800	146	57	0	0	3,900	3,950	487	373	265	166	75	0	0	0
1,800	1,825	150	60	0	0	3,950	4,000	496	382	272	173	82	0	0	0
1,825	1,850	154	64	0	0	4,000	4,050	504	390	280	181	88	3	0	0
1,850	1,875	157	67	0	0	4,050	4,100	513	399	287	188	95	9	0	0
1,875	1,900	161	70	0	0	4,100	4,150	521	407	295	195	102	16	0	0
1,900	1,925	164	73	0	0	4,150	4,200	530	416	303	202	109	22	0	0
1,925	1,950	168	77	0	0	4,200	4,250	538	424	310	209	115	28	0	0
1,950	1,975	172	80	0	0	4,250	4,300	547	433	319	217	122	35	0	0
1,975	2,000	175	83	0	0	4,300	4,350	556	442	328	224	129	41	0	0
2,000	2,025	179	87	2	0	4,350	4,400	564	450	336	231	136	47	0	0
2,025	2,050	182	90	5	0	4,400	4,450	573	459	345	239	142	54	0	0
2,050	2,075	186	93	8	0	4,450	4,500	581	467	353	247	149	60	0	0
2,075	2,100	190	97	11	0	4,500	4,550	590	476	362	254	157	66	0	0
2,100	2,125	193	100	14	0	4,550	4,600	598	484	370	262	164	73	0	0
2,125	2,150	197	104	17	0	4,600	4,650	607	493	379	270	171	79	0	0
2,150	2,175	200	107	20	0	4,650	4,700	615	501	387	277	178	86	1	0
2,175	2,200	204	110	24	0	4,700	4,750	624	510	396	285	185	93	7	0
2,200	2,225	208	114	27	0	4,750	4,800	633	519	405	293	193	100	14	0
2,225	2,250	211	117	30	0	4,800	4,850	641	527	413	300	200	106	20	0
2,250	2,275	215	120	33	0	4,850	4,900	650	536	422	308	207	113	26	0
2,275	2,300	218	124	36	0	4,900	4,950	658	544	430	316	214	120	33	0
2,300	2,325	222	127	39	0	4,950	5,000	667	553	439	325	221	127	39	0

"Table V—Married Persons Filing SEPARATE Returns

"MINIMUM STANDARD DEDUCTION

"Taxable Years Beginning After December 31, 1964

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—							
At least	But less than	1	2	3	4 or more	At least	But less than	1	2	3	4	5	6	7	8 or more
		The tax is—						The tax is—							
$0	$800	$0	$0	$0	$0	$2,400	$2,425	$244	$132	$30	$0	$0	$0	$0	$0
800	825	2	0	0	0	2,425	2,450	248	136	33	0	0	0	0	0
825	850	5	0	0	0	2,450	2,475	253	139	37	0	0	0	0	0
350	875	9	0	0	0	2,475	2,500	257	143	40	0	0	0	0	0
875	900	12	0	0	0	2,500	2,525	261	147	44	0	0	0	0	0
900	925	16	0	0	0	2,525	2,550	265	151	47	0	0	0	0	0
925	950	19	0	0	0	2,550	2,575	270	155	51	0	0	0	0	0
950	975	23	0	0	0	2,575	2,600	274	159	54	0	0	0	0	0
975	1,000	26	0	0	0	2,600	2,625	278	163	58	0	0	0	0	0
1,000	1,025	30	0	0	0	2,625	2,650	282	167	61	0	0	0	0	0
1,025	1,050	33	0	0	0	2,650	2,675	287	171	65	0	0	0	0	0
1,050	1,075	37	0	0	0	2,675	2,700	291	175	68	0	0	0	0	0
1,075	1,100	40	0	0	0	2,700	2,725	295	179	72	0	0	0	0	0
1,100	1,125	44	0	0	0	2,725	2,750	299	183	76	0	0	0	0	0
1,125	1,150	47	0	0	0	2,750	2,775	304	187	79	0	0	0	0	0
1,150	1,175	51	0	0	0	2,775	2,800	308	191	83	0	0	0	0	0
1,175	1,200	54	0	0	0	2,800	2,825	312	195	87	0	0	0	0	0
1,200	1,225	58	0	0	0	2,825	2,850	317	199	91	0	0	0	0	0
1,225	1,250	61	0	0	0	2,850	2,875	322	203	94	0	0	0	0	0
1,250	1,275	65	0	0	0	2,875	2,900	327	207	98	0	0	0	0	0
1,275	1,300	68	0	0	0	2,900	2,925	331	211	102	2	0	0	0	0
1,300	1,325	72	0	0	0	2,925	2,950	336	215	106	5	0	0	0	0
1,325	1,350	76	0	0	0	2,950	2,975	341	219	109	9	0	0	0	0
1,350	1,375	79	0	0	0	2,975	3,000	346	223	113	12	0	0	0	0
1,375	1,400	83	0	0	0	3,000	3,050	353	229	119	18	0	0	0	0
1,400	1,425	87	0	0	0	3,050	3,100	362	238	126	25	0	0	0	0
1,425	1,450	91	0	0	0	3,100	3,150	372	246	134	32	0	0	0	0
1,450	1,475	94	0	0	0	3,150	3,200	381	255	141	39	0	0	0	0
1,457	1,500	98	0	0	0	3,200	3,250	391	263	149	46	0	0	0	0
1,500	1,525	102	2	0	0	3,250	3,300	400	272	157	53	0	0	0	0
1,525	1,550	106	5	0	0	3,300	3,350	410	280	165	60	0	0	0	0
1,550	1,575	109	9	0	0	3,350	3,400	419	289	173	67	0	0	0	0
1,575	1,600	113	12	0	0	3,400	3,450	429	297	181	74	0	0	0	0
1,600	1,625	117	16	0	9	3,450	3,500	438	306	189	81	0	0	0	0
1,625	1,650	121	19	0	0	3,500	3,550	448	315	197	89	4	0	0	0
1,650	1,675	124	23	0	0	3,550	3,600	457	324	205	96	11	0	0	0
1,675	1,700	128	26	0	0	3,600	3,650	467	334	213	104	18	0	0	0
1,700	1,725	132	30	0	0	3,650	3,700	476	343	221	111	25	0	0	0
1,725	1,750	136	33	0	0	3,700	3,750	486	353	229	119	32	0	0	0
1,750	1,775	139	37	0	0	3,750	3,800	495	362	238	126	39	0	0	0
1,775	1,800	143	40	0	0	3,800	3,850	505	372	246	134	46	0	0	0
1,800	1,825	147	44	0	0	3,850	3,900	514	381	255	141	53	0	0	0
1,825	1,850	151	47	0	0	3,900	3,950	524	391	263	149	60	0	0	0
1,850	1,875	155	51	0	0	3,950	4,000	533	400	272	157	67	0	0	0
1,875	1,900	159	54	0	0	4,000	4,050	543	410	280	165	74	0	0	0
1,900	1,925	163	58	0	0	4,050	4,100	552	419	289	173	81	0	0	0
1,925	1,950	167	61	0	0	4,100	4,150	562	429	297	181	89	4	0	0
1,950	1,975	171	65	0	0	4,150	4,200	571	438	306	189	96	11	0	0
1,975	2,000	175	68	0	0	4,200	4,250	581	448	315	197	104	18	0	0
2,000	2,025	179	72	0	0	4,250	4,300	590	457	324	205	111	25	0	0
2,025	2,050	183	76	0	0	4,300	4,350	600	467	334	213	119	32	0	0
2,050	2,075	187	79	0	0	4,350	4,400	609	476	343	221	126	39	0	0
2,075	2,100	191	83	0	0	4,400	4,450	619	486	353	229	134	46	0	0
2,100	2,125	195	87	0	0	4,450	4,500	628	495	362	238	141	53	0	0
2,125	2,150	199	91	0	0	4,500	4,550	638	505	372	246	149	60	0	0
2,150	2,175	203	94	0	0	4,550	4,600	647	514	381	255	157	67	0	0
2,175	2,200	207	98	0	0	4,600	4,650	657	524	391	263	165	74	0	0
2,200	2,225	211	102	2	0	4,650	4,700	666	533	400	272	173	81	0	0
2,225	2,250	215	106	5	0	4,700	4,750	676	543	410	280	181	89	4	0
2,250	2,275	219	109	9	0	4,750	4,800	685	552	419	289	189	96	11	0
2,275	2,300	223	113	12	0	4,800	4,850	696	562	429	297	197	104	18	0
2,300	2,325	227	117	16	0	4,850	4,900	707	571	438	306	205	111	25	0
2,325	2,350	231	121	19	0	4,900	4,900	718	581	448	315	213	119	32	0
2,350	2,375	236	124	23	0	4,950	5,000	729	590	457	324	221	126	39	0"
2,375	2,400	240	128	26	0										

(b) Rules for Optional Tax.—

(1) Husband or wife filing separate returns.—Subsection (c) of section 4 (relating to rules for optional tax) is amended to read as follows:

"(c) Husband or Wife Filing Separate Return.—

"(1) A husband or wife may not elect to pay the optional tax imposed by section 3 if the tax of the other spouse is determined under section 1 on the basis of taxable income computed without regard to the standard deduction.

"(2) Except as otherwise provided in this subsection, in the case of a husband or wife filing a separate return the tax imposed by section 3 shall be—

"(A) for taxable years beginning in 1964, the lessor of the tax shown in Table IV or Table V of section 3(a), and

"(B) for taxable years beginning after December 31, 1964, the lessor of the tax shown in Table IV or Table V of section 3(b).

"(3) Neither Table V of section 3(a) nor Table V of section 3(b) shall apply in the case of a husband or wife filing a separate return if the tax of the other spouse is determined with regard to the 10-percent standard deduction; except that an individual described in section 141(d)(2) may elect (under regulations prescribed by the Secretary or his delegate)—

"(A) to pay the tax shown in Table V of section 3(a) in lieu of the tax shown in Table IV of section 3(a), and

"(B) to pay the tax shown in Table V of section 3(b) in lieu of the tax shown in Table IV of section 3(b).

For purposes of this title, an election under the preceding sentence shall be treated as an election made under section 141(d)(2).

"(4) For purposes of this subsection, determination of marital status shall be made under section 143."

(2) Amendment of section 6014.—Section 6014(a) (relating to income tax return—tax not computed by taxpayer) is amended by adding at the end thereof the following new sentence: "In the case of a married individual filing a separate return and electing the benefits of this subsection, neither Table V in section 3(a) nor Table V in section 3(b) shall apply."

(3) Technical amendments.—

(A) Subsection (a) of section 4 (relating to rules for optional tax) is amended by striking out "table" and inserting in lieu thereof "tables".

(B) Section 4(f) (relating to cross references) is amended by adding at the end thereof the following new paragraph:

"(4) For nonapplicability of Table V in section 3(a) and Table V in section 3(b) in case where tax is not computed by taxpayer, see section 6014(a)."

(c) Effective Date.—Except for purposes of section 21 of the Internal Revenue Code of 1954 (relating to effect of changes in rates during a taxable year), the amendments made by this section shall apply to taxable years beginning after December 31, 1963.

SEC. 302. INCOME TAX COLLECTED AT SOURCE.

(a) Percentage Method of Withholding.—Subsection (a) of section 3402 (relating to requirement of withholding) is amended by striking out "18 percent" and inserting in lieu thereof "14 percent".

(b) Wage Bracket Withholding.—Paragraph (1) of section 3402(c) (relating to wage bracket withholding) is amended to read as follows:

"(1) At the election of the employer with respect to any employee, the employer shall deduct and withhold upon the wages paid to such employee a tax determined in accordance with the following tables, which shall be in lieu of the tax required to be deducted and withheld under subsection (a):

"If the payroll period with respect to an employee is weekly—

And the wages are—		And the number of withholding exemptions claimed is—										
At least—	But less than—	0	1	2	3	4	5	6	7	8	9	10 or more
		The amount of income tax to be withheld shall be—										
$0	$13	14% of wages	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
$13	$14	1.90	.10	0	0	0	0	0	0	0	0	0
$14	$15	2.00	.20	0	0	0	0	0	0	0	0	0
$15	$16	2.20	.40	0	0	0	0	0	0	0	0	0
$16	$17	2.30	.50	0	0	0	0	0	0	0	0	0
$17	$18	2.50	.70	0	0	0	0	0	0	0	0	0
$18	$19	2.60	.80	0	0	0	0	0	0	0	0	0
$19	$20	2.70	.90	0	0	0	0	0	0	0	0	0
$20	$21	2.90	1.10	0	0	0	0	0	0	0	0	0
$21	$22	3.00	1.20	0	0	0	0	0	0	0	0	0
$22	$23	3.20	1.40	0	0	0	0	0	0	0	0	0
$23	$24	3.30	1.50	0	0	0	0	0	0	0	0	0
$24	$25	3.40	1.60	0	0	0	0	0	0	0	0	0
$25	$26	3.60	1.80	0	0	0	0	0	0	0	0	0
$26	$27	3.70	1.90	.10	0	0	0	0	0	0	0	0
$27	$28	3.90	2.10	.30	0	0	0	0	0	0	0	0
$28	$29	4.00	2.20	.40	0	0	0	0	0	0	0	0
$29	$30	4.10	2.30	.50	0	0	0	0	0	0	0	0
$30	$31	4.30	2.50	.70	0	0	0	0	0	0	0	0
$31	$32	4.40	2.60	.80	0	0	0	0	0	0	0	0
$32	$33	4.60	2.80	1.00	0	0	0	0	0	0	0	0
$33	$34	4.70	2.90	1.10	0	0	0	0	0	0	0	0
$34	$35	4.80	3.00	1.20	0	0	0	0	0	0	0	0
$35	$36	5.00	3.20	1.40	0	0	0	0	0	0	0	0
$36	$37	5.10	3.30	1.50	0	0	0	0	0	0	0	0
$37	$38	5.30	3.50	1.70	0	0	0	0	0	0	0	0
$38	$39	5.40	3.60	1.80	0	0	0	0	0	0	0	0
$39	$40	5.50	3.70	1.90	.10	0	0	0	0	0	0	0
$40	$41	5.70	3.90	2.10	.30	0	0	0	0	0	0	0
$41	$42	5.80	4.00	2.20	.40	0	0	0	0	0	0	0
$42	$43	6.00	4.20	2.40	.60	0	0	0	0	0	0	0
$43	$44	6.10	4.30	2.50	.70	0	0	0	0	0	0	0
$44	$45	6.20	4.40	2.60	.80	0	0	0	0	0	0	0
$45	$46	6.40	4.60	2.80	1.00	0	0	0	0	0	0	0
$46	$47	6.50	4.70	2.90	1.10	0	0	0	0	0	0	0
$47	$48	6.70	4.90	3.10	1.30	0	0	0	0	0	0	0
$48	$49	6.80	5.00	3.20	1.40	0	0	0	0	0	0	0
$49	$50	6.90	5.10	3.30	1.50	0	0	0	0	0	0	0
$50	$51	7.10	5.30	3.50	1.70	0	0	0	0	0	0	0
$51	$52	7.20	5.40	3.60	1.80	0	0	0	0	0	0	0
$52	$53	7.40	5.60	3.80	2.00	.20	0	0	0	0	0	0
$53	$54	7.50	5.70	3.90	2.10	.30	0	0	0	0	0	0
$54	$55	7.60	5.80	4.00	2.20	.50	0	0	0	0	0	0
$55	$56	7.80	6.00	4.20	2.40	.60	0	0	0	0	0	0
$56	$57	7.90	6.10	4.30	2.50	.70	0	0	0	0	0	0
$57	$58	8.10	6.30	4.50	2.70	.90	0	0	0	0	0	0
$58	$59	8.20	6.40	4.60	2.80	1.00	0	0	0	0	0	0
$59	$60	8.30	6.50	4.70	2.90	1.20	0	0	0	0	0	0
$60	$62	8.50	6.70	5.00	3.20	1.40	0	0	0	0	0	0
$62	$64	8.80	7.00	5.20	3.40	1.60	0	0	0	0	0	0
$64	$66	9.10	7.30	5.50	3.70	1.90	.10	0	0	0	0	0
$66	$68	9.40	7.60	5.80	4.00	2.20	.40	0	0	0	0	0
$68	$70	9.70	7.90	6.10	4.30	2.50	.70	0	0	0	0	0
$70	$72	9.90	8.10	6.40	4.60	2.80	1.00	0	0	0	0	0
$72	$74	10.20	8.40	6.60	4.80	[illegible]	1.20	0	0	0	0	0
$74	$76	10.50	8.70	6.90	5.10	3.30	1.50	0	0	0	0	0
$76	$78	10.80	9.00	7.20	5.40	3.60	1.80	0	0	0	0	0
$78	$80	11.10	9.30	7.50	5.70	3.90	2.10	.30	0	0	0	0
$80	$82	11.30	9.50	7.80	6.00	4.20	2.40	.60	0	0	0	0
$82	$84	11.60	9.80	8.00	6.20	4.40	2.60	.90	0	0	0	0
$84	$86	11.90	10.10	8.30	6.50	4.70	2.90	1.10	0	0	0	0
$86	$88	12.20	10.40	8.60	6.80	5.00	3.20	1.40	0	0	0	0
$88	$90	12.50	10.70	8.90	7.10	5.30	3.50	1.70	0	0	0	0
$90	$92	12.70	10.90	9.20	7.40	5.60	3.80	2.00	.20	0	0	0
$92	$94	13.00	11.20	9.40	7.60	5.80	4.00	2.30	.50	0	0	0
$94	$96	13.30	11.50	9.70	7.90	6.10	4.30	2.50	.70	0	0	0
$96	$98	13.60	11.80	10.00	8.20	6.40	4.60	2.80	1.00	0	0	0
$98	$100	13.90	12.10	10.30	8.50	6.70	4.90	3.10	1.30	0	0	0
$100	$105	14.40	12.60	10.80	9.00	7.20	5.40	3.60	1.80	0	0	0
$105	$110	15.10	13.30	11.50	9.70	7.90	6.10	4.30	2.50	.70	0	0
$110	$115	15.80	14.00	12.20	10.40	8.60	6.80	5.00	3.20	1.40	0	0
$115	$120	16.50	14.70	12.90	11.10	9.30	7.50	5.70	3.90	2.10	.30	0
$120	$125	17.20	15.40	13.60	11.80	10.00	8.20	6.40	4.60	2.80	1.00	0
$125	$130	17.90	16.10	14.30	12.50	10.70	8.90	7.10	5.30	3.50	1.70	0
$130	$135	18.60	16.80	15.00	13.20	11.40	9.60	7.80	6.00	4.20	2.40	.60
$135	$140	19.30	17.50	15.70	13.90	12.10	10.30	8.50	6.70	4.90	3.10	1.30
$140	$145	20.00	18.20	16.40	14.60	12.80	11.00	9.20	7.40	5.60	3.80	2.00
$145	$150	20.70	18.90	17.10	15.30	13.50	11.70	9.90	8.10	6.30	4.50	2.70
$150	$160	21.70	19.90	18.10	16.30	14.50	12.70	10.90	9.10	7.30	5.50	3.80
$160	$170	23.10	21.30	19.50	17.70	15.90	14.10	12.30	10.50	8.70	6.90	5.20
$170	$180	24.50	22.70	20.90	19.10	17.30	15.50	13.70	11.90	10.10	8.30	6.60
$180	$190	25.90	24.10	22.30	20.50	18.70	16.90	15.10	13.30	11.50	9.70	8.00
$190	$200	27.30	25.50	23.70	21.90	20.10	18.30	16.50	14.70	12.90	11.10	9.40
		14 percent of the excess over $200 plus—										
$200 and over		28.00	26.20	24.40	22.60	20.80	19.00	17.20	15.40	13.60	11.80	10.10

"If the payroll period with respect to an employee is biweekly—

And the wages are—		And the number of withholding exemptions claimed is—										
At least—	But less than—	0	1	2	3	4	5	6	7	8	9	10 or more
		The amount of income tax to be withheld shall be—										
$0	$26	14% of wages	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
$26	$28	$3.80	.20	0	0	0	0	0	0	0	0	0
$28	$30	4.10	.50	0	0	0	0	0	0	0	0	0
$30	$32	4.30	.80	0	0	0	0	0	0	0	0	0
$32	$34	4.60	1.00	0	0	0	0	0	0	0	0	0
$34	$36	4.90	1.30	0	0	0	0	0	0	0	0	0
$36	$38	5.20	1.60	0	0	0	0	0	0	0	0	0
$38	$40	5.50	1.90	0	0	0	0	0	0	0	0	0
$40	$42	5.70	2.20	0	0	0	0	0	0	0	0	0
$42	$44	6.00	2.40	0	0	0	0	0	0	0	0	0
$44	$46	6.30	2.70	0	0	0	0	0	0	0	0	0
$46	$48	6.60	3.00	0	0	0	0	0	0	0	0	0
$48	$50	6.90	3.30	0	0	0	0	0	0	0	0	0
$50	$52	7.10	3.60	0	0	0	0	0	0	0	0	0
$52	$54	7.40	3.80	.20	0	0	0	0	0	0	0	0
$54	$56	7.70	4.10	.50	0	0	0	0	0	0	0	0
$56	$58	8.00	4.40	.80	0	0	0	0	0	0	0	0
$58	$60	8.30	4.70	1.10	0	0	0	0	0	0	0	0
$60	$62	8.50	5.00	1.40	0	0	0	0	0	0	0	0
$62	$64	8.80	5.20	1.60	0	0	0	0	0	0	0	0
$64	$66	9.10	5.50	1.90	0	0	0	0	0	0	0	0
$66	$68	9.40	5.80	2.20	0	0	0	0	0	0	0	0
$68	$70	9.70	6.10	2.50	0	0	0	0	0	0	0	0
$70	$72	9.90	6.40	2.80	0	0	0	0	0	0	0	0
$72	$74	10.20	6.60	3.00	0	0	0	0	0	0	0	0
$74	$76	10.50	6.90	3.30	0	0	0	0	0	0	0	0
$76	$78	10.80	7.20	3.60	0	0	0	0	0	0	0	0
$78	$80	11.10	7.50	3.90	.30	0	0	0	0	0	0	0
$80	$82	11.30	7.80	4.20	.60	0	0	0	0	0	0	0
$82	$84	11.60	8.00	4.40	.90	0	0	0	0	0	0	0
$84	$86	11.90	8.30	4.70	1.10	0	0	0	0	0	0	0
$86	$88	12.20	8.60	5.00	1.40	0	0	0	0	0	0	0
$88	$90	12.50	8.90	5.30	1.70	0	0	0	0	0	0	0
$90	$92	12.70	9.20	5.60	2.00	0	0	0	0	0	0	0
$92	$94	13.00	9.40	5.80	2.30	0	0	0	0	0	0	0
$94	$96	13.30	9.70	6.10	2.50	0	0	0	0	0	0	0
$96	$98	13.60	10.00	6.40	2.80	0	0	0	0	0	0	0
$98	$100	13.90	10.30	6.70	3.10	0	0	0	0	0	0	0
$100	$102	14.10	10.60	7.00	3.40	0	0	0	0	0	0	0
$102	$104	14.40	10.80	7.20	3.70	.10	0	0	0	0	0	0
$104	$106	14.70	11.10	7.50	3.90	.30	0	0	0	0	0	0
$106	$108	15.00	11.40	7.80	4.20	.60	0	0	0	0	0	0
$108	$110	15.30	11.70	8.10	4.50	.90	0	0	0	0	0	0
$110	$112	15.50	12.00	8.40	4.80	1.20	0	0	0	0	0	0
$112	$114	15.80	12.20	8.60	5.10	1.50	0	0	0	0	0	0
$114	$116	16.10	12.50	8.90	5.30	1.70	0	0	0	0	0	0
$116	$118	16.40	12.80	9.20	5.60	2.00	0	0	0	0	0	0
$118	$120	16.70	13.10	9.50	5.90	2.30	0	0	0	0	0	0
$120	$124	17.10	13.50	9.90	6.30	2.70	0	0	0	0	0	0
$124	$128	17.60	14.10	10.50	6.90	3.30	0	0	0	0	0	0
$128	$132	18.20	14.60	11.00	7.40	3.80	.30	0	0	0	0	0
$132	$136	18.80	15.20	11.60	8.00	4.40	.80	0	0	0	0	0
$136	$140	19.30	15.70	12.10	8.60	5.00	1.40	0	0	0	0	0
$140	$144	19.90	16.30	12.70	9.10	5.50	1.90	0	0	0	0	0
$144	$148	20.40	16.90	13.30	9.70	6.10	2.50	0	0	0	0	0
$148	$152	21.00	17.40	13.80	10.20	6.60	3.10	0	0	0	0	0
$152	$156	21.60	18.00	14.40	10.80	7.20	3.60	0	0	0	0	0
$156	$160	22.10	18.50	14.90	11.40	7.80	4.20	.60	0	0	0	0
$160	$164	22.70	19.10	15.50	11.90	8.30	4.70	1.10	0	0	0	0
$164	$168	23.20	19.70	16.10	12.50	8.90	5.30	1.70	0	0	0	0
$168	$172	23.80	20.20	16.60	13.00	9.40	5.90	2.30	0	0	0	0
$172	$176	24.40	20.80	17.20	13.60	10.00	6.40	2.80	0	0	0	0
$176	$180	24.90	21.30	17.70	14.20	10.60	7.00	3.40	0	0	0	0
$180	$184	25.50	21.90	18.30	14.70	11.10	7.50	3.90	.40	0	0	0
$184	$188	26.00	22.50	18.90	15.30	11.70	8.10	4.50	.90	0	0	0
$188	$192	26.60	23.00	19.40	15.80	12.20	8.70	5.10	1.50	0	0	0
$192	$196	27.20	23.60	20.00	16.40	12.80	9.20	5.60	2.00	0	0	0
$196	$200	27.70	24.10	20.50	17.00	13.40	9.80	6.20	2.60	0	0	0
$200	$210	28.70	25.10	21.50	17.90	14.30	10.80	7.20	3.60	0	0	0
$210	$220	30.10	26.50	22.90	19.30	15.70	12.20	8.60	5.00	1.40	0	0
$220	$230	31.50	27.90	24.30	20.70	17.10	13.60	10.00	6.40	2.80	0	0
$230	$240	32.90	29.30	25.70	22.10	18.50	15.00	11.40	7.80	4.20	.60	0
$240	$250	34.30	30.70	27.10	23.50	19.90	16.40	12.80	9.20	5.60	2.00	0
$250	$260	35.70	32.10	28.50	24.90	21.30	17.80	14.20	10.60	7.00	3.40	0
$260	$270	37.10	33.50	29.90	26.30	22.70	19.20	15.60	12.00	8.40	4.80	1.20
$270	$280	38.50	34.90	31.30	27.70	24.10	20.60	17.00	13.40	9.80	6.20	2.60
$280	$290	39.90	36.30	32.70	29.10	25.50	22.00	18.40	14.80	11.20	7.60	4.00
$290	$300	41.30	37.70	34.10	30.50	26.90	23.40	19.80	16.20	12.60	9.00	5.40
$300	$320	43.40	39.80	36.20	32.60	29.00	25.50	21.90	18.30	14.70	11.10	7.50
$320	$340	46.20	42.60	[illegible]	35.40	31.80	28.30	24.70	21.10	17.50	13.90	10.30
$340	$360	49.00	45.40	41.80	38.20	34.60	31.10	27.50	23.90	20.30	16.70	13.10
$360	$380	51.80	48.20	44.60	41.00	37.40	33.90	30.30	26.70	23.10	19.50	15.90
$380	$400	54.60	51.00	47.40	43.80	40.20	36.70	33.10	29.50	25.90	22.30	18.70
		14 percent of the excess over $400 plus—										
$400 and over		56.00	52.40	48.80	45.20	41.60	38.10	34.50	30.90	27.03	23.70	20.10

"If the payroll period with respect to an employee is semimonthly—

And the wages are—		And the number of withholding exemptions claimed is—										
At least—	But less than—	0	1	2	3	4	5	6	7	8	9	10 or more
		The amount of income tax to be withheld shall be—										
$0	$28	14% of wages	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
$28	$30	$4.10	.20	0	0	0	0	0	0	0	0	0
$30	$32	4.30	.50	0	0	0	0	0	0	0	0	0
$32	$34	4.60	.70	0	0	0	0	0	0	0	0	0
$34	$36	4.90	1.00	0	0	0	0	0	0	0	0	0
$36	$38	5.20	1.30	0	0	0	0	0	0	0	0	0
$38	$40	5.50	1.60	0	0	0	0	0	0	0	0	0
$40	$42	5.70	1.90	0	0	0	0	0	0	0	0	0
$42	$44	6.00	2.10	0	0	0	0	0	0	0	0	0
$44	$46	6.30	2.40	0	0	0	0	0	0	0	0	0
$46	$48	6.60	2.70	0	0	0	0	0	0	0	0	0
$48	$50	6.90	3.00	0	0	0	0	0	0	0	0	0
$50	$52	7.10	3.30	0	0	0	0	0	0	0	0	0
$52	$54	7.40	3.50	0	0	0	0	0	0	0	0	0
$54	$56	7.70	3.80	0	0	0	0	0	0	0	0	0
$56	$58	8.00	4.10	.20	0	0	0	0	0	0	0	0
$58	$60	8.30	4.40	.50	0	0	0	0	0	0	0	0
$60	$62	8.50	4.70	.80	0	0	0	0	0	0	0	0
$62	$64	8.80	4.90	1.00	0	0	0	0	0	0	0	0
$64	$66	9.10	5.20	1.30	0	0	0	0	0	0	0	0
$66	$68	9.40	5.50	1.60	0	0	0	0	0	0	0	0
$68	$70	9.70	5.80	1.90	0	0	0	0	0	0	0	0
$70	$72	9.90	6.10	2.20	0	0	0	0	0	0	0	0
$72	$74	10.20	6.30	2.40	0	0	0	0	0	0	0	0
$74	$76	10.50	6.60	2.70	0	0	0	0	0	0	0	0
$76	$78	10.80	6.90	3.00	0	0	0	0	0	0	0	0
$78	$80	11.10	7.20	3.30	0	0	0	0	0	0	0	0
$80	$82	11.30	7.50	3.60	0	0	0	0	0	0	0	0
$82	$84	11.60	7.70	3.80	0	0	0	0	0	0	0	0
$84	$86	11.90	8.00	4.10	.20	0	0	0	0	0	0	0
$86	$88	12.20	8.30	4.40	.50	0	0	0	0	0	0	0
$88	$90	12.50	8.60	4.70	.80	0	0	0	0	0	0	0
$90	$92	12.70	8.90	5.00	1.10	0	0	0	0	0	0	0
$92	$94	13.00	9.10	5.20	1.40	0	0	0	0	0	0	0
$94	$96	13.30	9.40	5.50	1.60	0	0	0	0	0	0	0
$96	$98	13.60	9.70	5.80	1.90	0	0	0	0	0	0	0
$98	$100	13.90	10.00	6.10	2.20	0	0	0	0	0	0	0
$100	$102	14.10	10.30	6.40	2.50	0	0	0	0	0	0	0
$102	$104	14.40	10.50	6.60	2.80	0	0	0	0	0	0	0
$104	$106	14.70	10.80	6.90	3.00	0	0	0	0	0	0	0
$106	$108	15.00	11.10	7.20	3.30	0	0	0	0	0	0	0
$108	$110	15.30	11.40	7.50	3.60	0	0	0	0	0	0	0
$110	$112	15.50	11.70	7.80	3.90	0	0	0	0	0	0	0
$112	$114	15.80	11.90	8.00	4.20	.30	0	0	0	0	0	0
$114	$116	16.10	12.20	8.30	4.40	.50	0	0	0	0	0	0
$116	$118	16.40	12.50	8.60	4.70	.80	0	0	0	0	0	0
$118	$120	16.70	12.80	8.90	5.00	1.10	0	0	0	0	0	0
$120	$124	17.10	13.20	9.30	5.40	1.50	0	0	0	0	0	0
$124	$128	17.60	13.80	9.90	6.00	2.10	0	0	0	0	0	0
$128	$132	18.20	14.30	10.40	6.50	2.60	0	0	0	0	0	0
$132	$136	18.80	14.90	11.00	7.10	3.20	0	0	0	0	0	0
$136	$140	19.30	15.40	11.50	7.70	3.80	0	0	0	0	0	0
$140	$144	19.90	16.00	12.10	8.20	4.30	.40	0	0	0	0	0
$144	$148	20.40	16.60	12.70	8.80	4.90	1.00	0	0	0	0	0
$148	$152	21.00	17.10	13.20	9.30	5.40	1.60	0	0	0	0	0
$152	$156	21.60	17.70	13.80	9.90	6.00	2.10	0	0	0	0	0
$156	$160	22.10	18.20	14.30	10.50	6.60	2.70	0	0	0	0	0
$160	$164	22.70	18.80	14.90	11.00	7.10	3.20	0	0	0	0	0
$164	$168	23.20	19.40	15.50	11.60	7.70	3.80	0	0	0	0	0
$168	$172	23.80	19.90	16.00	12.10	8.20	4.40	.50	0	0	0	0
$172	$176	24.40	20.50	16.60	12.70	8.80	4.90	1.00	0	0	0	0
$176	$180	24.90	21.00	17.10	13.30	9.40	5.50	1.60	0	0	0	0
$180	$184	25.50	21.60	17.70	13.80	9.90	6.00	2.10	0	0	0	0
$184	$188	26.00	22.20	18.30	14.40	10.50	6.60	2.70	0	0	0	0
$188	$192	26.60	22.70	18.80	14.90	11.00	7.20	3.30	0	0	0	0
$192	$196	27.20	23.30	19.40	15.50	11.60	7.70	3.80	0	0	0	0
$196	$200	27.70	23.80	19.90	16.10	12.20	8.30	4.40	.50	0	0	0
$200	$210	28.70	24.80	20.90	17.00	13.10	9.30	5.40	1.50	0	0	0
$210	$220	30.10	26.20	22.30	18.40	14.50	10.70	6.80	2.90	0	0	0
$220	$230	31.50	27.60	23.70	19.80	15.90	12.10	8.20	4.30	.40	0	0
$230	$240	32.90	29.00	25.10	21.20	17.30	13.50	9.60	5.70	1.80	0	0
$240	$250	34.30	30.40	26.50	22.60	18.70	14.90	11.00	7.10	3.20	0	0
$250	$260	35.70	31.80	27.90	24.00	20.10	16.30	12.40	8.50	4.60	.70	0
$260	$270	37.10	33.20	29.30	25.40	21.50	17.70	13.80	9.90	6.00	2.10	0
$270	$280	38.50	34.60	30.70	26.80	22.90	19.10	15.20	11.30	7.40	3.50	0
$280	$290	39.90	36.00	32.10	28.20	24.30	20.50	16.60	12.70	8.80	4.90	1.00
$290	$300	41.30	37.40	33.50	29.60	25.70	21.90	18.00	14.10	10.20	6.30	2.40
$300	$320	43.40	39.50	35.60	31.70	27.80	24.00	20.10	16.20	12.30	8.40	4.50
$320	$340	46.20	42.30	38.40	34.50	30.60	26.80	22.90	19.00	15.10	11.20	7.30
$340	$360	49.00	45.10	41.20	37.30	33.40	29.60	25.70	21.80	17.90	14.00	10.10
$360	$380	51.80	47.90	44.00	40.10	36.20	32.40	28.50	24.60	20.70	16.80	12.90
$380	$400	54.60	50.70	46.80	42.90	39.00	35.20	31.30	27.40	23.50	19.60	15.70
$400	$420	57.40	53.50	49.60	45.70	41.80	38.00	34.10	30.20	26.30	22.40	18.50
$420	$440	60.20	56.30	52.40	48.50	44.60	40.80	36.90	33.00	29.10	25.20	21.30
$440	$460	63.00	59.10	55.20	51.30	47.40	43.60	39.70	35.80	31.90	28.00	24.10
$460	$480	65.80	61.90	58.00	54.10	50.20	46.40	42.50	38.60	34.70	30.80	26.90
$480	$500	68.60	64.70	60.80	56.90	53.00	49.20	45.30	41.40	37.50	33.60	29.70
		14 percent of the excess over $500 plus—										
$500 and over		70.00	66.10	62.20	58.30	54.40	50.60	46.70	42.80	38.90	35.00	31.10

"If the payroll period with respect to an employee is monthly—

And the wages are—		And the number of withholding exemptions claimed is—										
At least—	But less than—	0	1	2	3	4	5	6	7	8	9	10 or more
		The amount of income tax to be withheld shall be—										
$0	$56	14% of wages	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
$56	$60	$8.10	.30	0	0	0	0	0	0	0	0	0
$60	$64	8.70	.90	0	0	0	0	0	0	0	0	0
$64	$68	9.20	1.50	0	0	0	0	0	0	0	0	0
$68	$72	9.80	2.00	0	0	0	0	0	0	0	0	0
$72	$76	10.40	2.60	0	0	0	0	0	0	0	0	0
$76	$80	10.90	3.10	0	0	0	0	0	0	0	0	0
$80	$84	11.50	3.70	0	0	0	0	0	0	0	0	0
$84	$88	12.00	4.30	0	0	0	0	0	0	0	0	0
$88	$92	12.60	4.80	0	0	0	0	0	0	0	0	0
$92	$96	13.20	5.40	0	0	0	0	0	0	0	0	0
$96	$100	13.70	5.90	0	0	0	0	0	0	0	0	0
$100	$104	14.30	6.50	0	0	0	0	0	0	0	0	0
$104	$108	14.80	7.10	0	0	0	0	0	0	0	0	0
$108	$112	15.40	7.60	0	0	0	0	0	0	0	0	0
$112	$116	16.00	8.20	.40	0	0	0	0	0	0	0	0
$116	$120	16.50	8.70	1.00	0	0	0	0	0	0	0	0
$120	$124	17.10	9.30	1.50	0	0	0	0	0	0	0	0
$124	$128	17.60	9.90	2.10	0	0	0	0	0	0	0	0
$128	$132	18.20	10.40	2.60	0	0	0	0	0	0	0	0
$132	$136	18.80	11.00	3.20	0	0	0	0	0	0	0	0
$136	$140	19.30	11.50	3.80	0	0	0	0	0	0	0	0
$140	$144	19.90	12.10	4.30	0	0	0	0	0	0	0	0
$144	$148	20.40	12.70	4.90	0	0	0	0	0	0	0	0
$148	$152	21.00	13.20	5.40	0	0	0	0	0	0	0	0
$152	$156	21.60	13.80	6.00	0	0	0	0	0	0	0	0
$156	$160	22.10	14.30	6.60	0	0	0	0	0	0	0	0
$160	$164	22.70	14.90	7.10	0	0	0	0	0	0	0	0
$164	$168	23.20	15.50	7.70	0	0	0	0	0	0	0	0
$168	$172	23.80	16.00	8.20	.50	0	0	0	0	0	0	0
$172	$176	24.40	16.60	8.80	1.00	0	0	0	0	0	0	0
$176	$180	24.90	17.10	9.40	1.60	0	0	0	0	0	0	0
$180	$184	25.50	17.70	9.90	2.10	0	0	0	0	0	0	0
$184	$188	26.00	18.30	10.50	2.70	0	0	0	0	0	0	0
$188	$192	26.60	18.80	11.00	3.30	0	0	0	0	0	0	0
$192	$196	27.20	19.40	11.60	3.80	0	0	0	0	0	0	0
$196	$200	27.70	19.90	12.20	4.40	0	0	0	0	0	0	0
$200	$204	28.30	20.50	12.70	4.90	0	0	0	0	0	0	0
$204	$208	28.80	21.10	13.30	5.50	0	0	0	0	0	0	0
$208	$212	29.40	21.60	13.80	6.10	0	0	0	0	0	0	0
$212	$216	30.00	22.20	14.40	6.60	0	0	0	0	0	0	0
$216	$220	30.50	22.70	15.00	7.20	0	0	0	0	0	0	0
$220	$224	31.10	23.30	15.50	7.70	0	0	0	0	0	0	0
$224	$228	31.60	23.90	16.10	8.30	.50	0	0	0	0	0	0
$228	$232	32.20	24.40	16.60	8.90	1.10	0	0	0	0	0	0
$232	$236	32.80	25.00	17.20	9.40	1.60	0	0	0	0	0	0
$236	$240	33.30	25.50	17.80	10.00	2.20	0	0	0	0	0	0
$240	$248	34.20	26.40	18.60	10.80	3.00	0	0	0	0	0	0
$248	$256	35.30	27.50	19.70	11.90	4.20	0	0	0	0	0	0
$256	$264	36.40	28.60	20.80	13.10	5.30	0	0	0	0	0	0
$264	$272	37.50	29.70	22.00	14.20	6.40	0	0	0	0	0	0
$272	$280	38.60	30.90	23.10	15.30	7.50	0	0	0	0	0	0
$280	$288	39.80	32.00	24.20	16.40	8.60	.90	0	0	0	0	0
$288	$296	40.90	33.10	25.30	17.50	9.80	2.00	0	0	0	0	0
$296	$304	42.00	34.20	26.40	18.70	10.90	3.10	0	0	0	0	0
$304	$312	43.10	35.30	27.60	19.80	12.00	4.20	0	0	0	0	0
$312	$320	44.20	36.50	28.70	20.90	13.10	5.40	0	0	0	0	0
$320	$328	45.40	37.60	29.80	22.00	14.20	6.50	0	0	0	0	0
$328	$336	46.50	38.70	30.90	23.10	15.40	7.60	0	0	0	0	0
$336	$344	47.60	39.80	32.00	24.30	16.50	8.70	.90	0	0	0	0
$344	$352	48.70	40.90	33.20	25.40	17.60	9.80	2.10	0	0	0	0
$352	$360	49.80	42.10	34.30	26.50	18.70	11.00	3.20	0	0	0	0
$360	$368	51.00	43.20	35.40	27.60	19.80	12.10	4.30	0	0	0	0
$368	$376	52.10	44.30	36.50	28.70	21.00	13.20	5.40	0	0	0	0
$376	$384	53.20	45.40	37.60	29.90	22.10	14.30	6.50	0	0	0	0
$384	$392	54.30	46.50	38.80	31.00	23.20	15.40	7.70	0	0	0	0
$392	$400	55.40	47.70	39.90	32.10	24.30	16.60	8.80	1.00	0	0	0
$400	$420	57.40	49.60	41.80	34.10	26.30	18.50	10.70	3.00	0	0	0
$420	$440	60.20	52.40	44.60	36.90	29.10	21.30	13.50	5.80	0	0	0
$440	$460	63.00	55.20	47.40	39.70	31.90	24.10	16.30	8.60	.80	0	0
$460	$480	65.80	58.00	50.20	42.50	34.70	26.90	19.10	11.40	3.60	0	0
$480	$500	68.60	60.80	53.00	45.30	37.50	29.70	21.90	14.20	6.40	0	0
$500	$520	71.40	63.60	55.80	48.10	40.30	32.50	24.70	17.00	9.20	1.40	0
$520	$540	74.20	66.40	58.60	50.90	43.10	35.30	27.50	19.80	12.00	4.20	0
$540	$560	77.00	69.20	61.40	53.70	45.90	38.10	30.30	22.60	14.80	7.00	0
$560	$580	79.80	72.00	64.20	56.50	48.70	40.90	33.10	25.40	17.60	9.80	2.00
$580	$600	82.60	74.80	67.00	59.30	51.50	43.70	35.90	28.20	20.40	12.60	4.80
$600	$640	86.80	79.00	71.20	63.50	55.70	47.90	40.10	32.40	24.60	16.80	9.00
$640	$680	92.40	84.60	76.80	69.10	61.30	53.50	45.70	38.00	30.20	22.40	14.60
$680	$720	98.00	90.20	82.40	74.70	66.90	59.10	51.30	43.60	35.80	28.00	20.20
$720	$760	103.60	95.80	88.00	80.30	72.50	64.70	56.90	49.20	41.40	33.60	25.80
$760	$800	109.20	101.40	93.60	85.90	78.10	70.30	62.50	54.80	47.00	39.20	31.40
$800	$840	114.80	107.00	99.20	91.50	83.70	75.90	68.10	60.40	52.60	44.80	37.00
$840	$880	120.40	112.60	104.80	97.10	89.30	81.50	73.70	66.00	58.20	50.40	42.60
$880	$920	126.00	118.20	110.40	102.70	94.90	87.10	79.30	71.60	63.80	56.00	48.20
$920	$960	131.60	123.80	116.00	108.30	100.50	92.70	84.90	77.20	69.40	61.60	53.80
$960	$1,000	137.20	129.40	121.60	113.90	106.10	98.30	90.50	82.80	75.00	67.20	59.40
		14 percent of the excess over $1,000 plus—										
$1,000 and over		140.00	132.20	124.40	116.70	108.90	101.10	93.30	85.60	77.80	70.00	62.20

"If the payroll period with respect to an employee is a daily payroll period or a miscellaneous payroll period—

And the wages divided by the number of days in such period are—		And the number of withholding exemptions claimed is—										
		0	1	2	3	4	5	6	7	8	9	10 or more
At least—	But less than—	The amount of tax to be withheld shall be the following amount multiplied by the number of days in such period—										
$0	$2.00	14% of wages	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
$2.00	$2.25	$.30	.05	0	0	0	0	0	0	0	0	0
$2.25	$2.50	.35	.10	0	0	0	0	0	0	0	0	0
$2.50	$2.75	.35	.10	0	0	0	0	0	0	0	0	0
$2.75	$3.00	.40	.15	0	0	0	0	0	0	0	0	0
$3.00	$3.25	.45	.20	0	0	0	0	0	0	0	0	0
$3.25	$3.50	.45	.20	0	0	0	0	0	0	0	0	0
$3.50	$3.75	.50	.25	0	0	0	0	0	0	0	0	0
$3.75	$4.00	.55	.30	.05	0	0	0	0	0	0	0	0
$4.00	$4.25	.60	.30	.05	0	0	0	0	0	0	0	0
$4.25	$4.50	.60	.35	.10	0	0	0	0	0	0	0	0
$4.50	$4.75	.65	.40	.15	0	0	0	0	0	0	0	0
$4.75	$5.00	.70	.45	.15	0	0	0	0	0	0	0	0
$5.00	$5.25	.70	.45	.20	0	0	0	0	0	0	0	0
$5.25	$5.50	.75	.50	.25	0	0	0	0	0	0	0	0
$5.50	$5.75	.80	.55	.30	0	0	0	0	0	0	0	0
$5.75	$6.00	.80	.55	.30	.05	0	0	0	0	0	0	0
$6.00	$6.25	.85	.60	.35	.10	0	0	0	0	0	0	0
$6.25	$6.50	.90	.65	.40	.15	0	0	0	0	0	0	0
$6.50	$6.75	.95	.65	.40	.15	0	0	0	0	0	0	0
$6.75	$7.00	.95	.70	.45	.20	0	0	0	0	0	0	0
$7.00	$7.25	1.00	.75	.50	.25	0	0	0	0	0	0	0
$7.25	$7.50	1.05	.80	.50	.25	0	0	0	0	0	0	0
$7.50	$7.75	1.05	.80	.55	.30	.05	0	0	0	0	0	0
$7.75	$8.00	1.10	.85	.60	.35	.10	0	0	0	0	0	0
$8.00	$8.25	1.15	.90	.65	.35	.10	0	0	0	0	0	0
$8.25	$8.50	1.15	.90	.65	.40	.15	0	0	0	0	0	0
$8.50	$8.75	1.20	.95	.70	.45	.20	0	0	0	0	0	0
$8.75	$9.00	1.25	1.00	.75	.50	.20	0	0	0	0	0	0
$9.00	$9.25	1.30	1.00	.75	.50	.25	0	0	0	0	0	0
$9.25	$9.50	1.30	1.05	.80	.55	.30	.05	0	0	0	0	0
$9.50	$9.75	1.35	1.10	.85	.60	.30	.05	0	0	0	0	0
$9.75	$10.00	1.40	1.15	.85	.60	.35	.10	0	0	0	0	0
$10.00	$10.50	1.45	1.20	.90	.65	.40	.15	0	0	0	0	0
$10.50	$11.00	1.50	1.25	1.00	.75	.50	.25	0	0	0	0	0
$11.00	$11.50	1.60	1.30	1.05	.80	.55	.30	.05	0	0	0	0
$11.50	$12.00	1.65	1.40	1.15	.90	.60	.35	.10	0	0	0	0
$12.00	$12.50	1.70	1.45	1.20	.95	.70	.45	.20	0	0	0	0
$12.50	$13.00	1.80	1.55	1.25	1.00	.75	.50	.25	0	0	0	0
$13.00	$13.50	1.85	1.60	1.35	1.10	.85	.60	.30	.05	0	0	0
$13.50	$14.00	1.95	1.65	1.40	1.15	.90	.65	.40	.15	0	0	0
$14.00	$14.50	2.00	1.75	1.50	1.25	.95	.70	.45	.20	0	0	0
$14.50	$15.00	2.05	1.80	1.55	1.30	1.05	.80	.55	.30	0	0	0
$15.00	$15.50	2.15	1.90	1.60	1.35	1.10	.85	.60	.35	.10	0	0
$15.50	$16.00	2.20	1.95	1.70	1.45	1.20	.95	.65	.40	.15	0	0
$16.00	$16.50	2.30	2.00	1.75	1.50	1.25	1.00	.75	.50	.25	0	0
$16.50	$17.00	2.35	2.10	1.85	1.60	1.30	1.05	.80	.55	.30	.05	0
$17.00	$17.50	2.40	2.15	1.90	1.65	1.40	1.15	.90	.65	.35	.10	0
$17.50	$18.00	2.50	2.25	1.95	1.70	1.45	1.20	.95	.70	.45	.20	0
$18.00	$18.50	2.55	2.30	2.05	1.80	1.55	1.30	1.00	.75	.50	.25	0
$18.50	$19.00	2.65	2.35	2.10	1.85	1.60	1.35	1.10	.85	.60	.30	.05
$19.00	$19.50	2.70	2.45	2.20	1.95	1.65	1.40	1.15	.90	.65	.40	.15
$19.50	$20.00	2.75	2.50	2.25	2.00	1.75	1.50	1.25	1.00	.70	.45	.20
$20.00	$21.00	2.85	2.60	2.35	2.10	1.85	1.60	1.35	1.10	.80	.55	.30
$21.00	$22.00	3.00	2.75	2.50	2.25	2.00	1.75	1.50	1.20	.95	.70	.45
$22.00	$23.00	3.15	2.90	2.65	2.40	2.15	1.85	1.60	1.35	1.10	.85	.60
$23.00	$24.00	3.30	3.05	2.80	2.50	2.25	2.00	1.75	1.50	1.25	1.00	.75
$24.00	$25.00	3.45	3.15	2.90	2.65	2.40	2.15	1.90	1.65	1.40	1.15	.85
$25.00	$26.00	3.55	3.30	3.05	2.80	2.55	2.30	2.05	1.80	1.50	1.25	1.00
$26.00	$27.00	3.70	3.45	3.20	2.95	2.70	2.45	2.20	1.90	1.65	1.40	1.15
$27.00	$28.00	3.85	3.60	3.35	3.10	2.85	2.55	2.30	2.05	1.80	1.55	1.30
$28.00	$29.00	4.00	3.75	3.50	3.20	2.95	2.70	2.45	2.20	1.95	1.70	1.45
$29.00	$30.00	4.15	3.85	3.60	3.35	3.10	2.85	2.60	2.35	2.10	1.85	1.55
		14 percent of the excess over $30 plus—										
$30 and over		4.20	3.95	3.70	3.45	3.20	2.90	2.65	2.40	2.15	1.90	1.65"

(c) Withholding of Tax on Certain Nonresident Aliens.—Subsections (a) and (b) of section 1441 (relating to withholding of tax on nonresident aliens) are amended by striking out "18 percent" and inserting in lieu thereof "14 percent".

(d) Effective Dates.—The amendments made by subsections (a) and (b) of this section shall apply with respect to remuneration paid after the seventh day following the date of the enactment of this Act. The amendment made by subsection (c) of this section shall apply with respect to payments made after the seventh day following the date of the enactment of this Act.

Approved February 26, 1964.

PUBLIC LAW 88-300
EIGHTY-EIGHTH CONGRESS, APRIL 29, 1964
S. 2394 [1]

An Act to facilitate compliance with the convention between the United States of America and the United Mexican States, signed August 29, 1963, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "American-Mexican Chamizal Convention Act of 1964."

In connection with the convention between the United States of America and the United Mexican States for the solution of the problem of the Chamizal, signed August 29, 1963, the Secretary of State, acting through the United States Commissioner, International Boundary and Water Commission, United States and Mexico, is authorized—

a. to conduct technical and other investigations relating to: the demarcation or monumentation of the boundary between the United States and Mexico; flood control; water resources; sanitation and prevention of pollution; channel relocation, improvement, and stabilization; and other matters related to the new river channel.

b. to acquire by donation, purchase, or condemnation, all lands required—

(1) for transfer to Mexico as provided in said convention;

(2) for construction of that portion of the new river channel and the adjoining levee in the territory of the United States;

(3) for relocation of highways, roadways, railroads, telegraph, telephone, electric transmission lines, bridges, related facilities, and any publicly owned structure or facility, the relocation of which, in the judgment of the said Commissioner, is necessitated by the project.

c. For the purpose of effecting said relocations—

(1) to perform any or all work involved in said relocations;

(2) to enter into contracts with the owners of properties to be relocated whereby they undertake to acquire any or all properties needed for said relocations, or undertake to perform any or all work involved in said relocations;

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[1] Senate Report No. 868, page 838, this Bulletin; since House Report No. 1233 is substantially the same as the Senate Report, it is not published herein.

(3) to convey or exchange properties acquired or improved by the United States under this Act or under said convention, with or without improvements, or to grant term or perpetual easements therein or thereover.

SEC. 2. The United States Commissioner is authorized to construct, operate, and maintain all works provided for in said convention and this Act, and to turn over the operation and maintenance of any such works to any Federal agency, or any State, county, municipality, district, or other political subdivision within which such project or works may be in whole or in part situated, upon such terms, conditions, and requirements as the Commissioner may deem appropriate.

SEC. 3. The United States Commissioner, under regulations approved by the Secretary of State, and upon application of the owners and tenants of lands to be acquired by the United States to fulfill and accomplish the purposes of said convention, and to the extent administratively determined by the Commissioner to be fair and reasonable, is authorized to—

a. Reimburse the owners and tenants for expenses and other losses and damages incurred by them in the process and as a direct result of such moving of themselves, their families, and their possessions as is occasioned by said acquisition: *Provided*, That the total of such reimbursement to the owners and tenants of any parcel of land shall in no event exceed 25 per centum of its fair value, as determined by the Commissioner. No payment under this subsection shall be made unless application therefor is supported by an itemized and certified statement of the expenses, losses, and damages incurred.

b. Compensate the said owners and tenants for identifiable, reasonable, and satisfactorily proved costs and losses to owners and tenants over and above those reimbursed under the foregoing subsection in the categories hereinafter provided, and for which purpose there shall be established by the Commissioner a board of examiners, consisting of such personnel employed and compensation fixed as he deems advisable, without regard to the provisions of the civil service laws and the Classification Act of 1949, as amended. Said board may hold hearings and shall examine submitted evidence and make determinations, subject to the Commissioner's approval, regarding all claims in said categories as follows:

(1) For properties—

(a) For nonconforming abodes and minimum forms of shelter for which there are no comparable properties on the market in the city of El Paso and concerning which fair market value would be inadequate to find minimum housing of equal utility, compensation to the owner up to an amount which when added to the market value allowed for his property, including land values, would enable purchase of minimum habitable housing of similar utility in another residential section of said city.

(b) For commercial properties for which there are no comparable properties on the market in or near El

Paso, Texas, compensation to the owner up to an amount which, when added to the total fair market value, including the land value, would compensate the owner for the "value in use" of the real estate to him. Such "value in use" is to be determined on the basis of replacement cost less deterioration and obsolescence in existing real estate and taking into consideration factors bearing upon income attributable to the real estate.

(2) For loss in business:

(a) Loss of profits directly resulting from relocation, limited to the period between termination of business in the old location and commencement of business in the new, such period not to exceed thirty days.

(b) Loss to owner resulting from inability to rent to others housing or commercial space that can be reasonably related to uncertainties arising out of the pending acquisition of the owner's property by the United States, such losses limited to those incurred after July 18, 1963, and prior to the making by the United States of a firm offer to purchase.

(3) For penalty costs to property owners for prepayment of mortgages incident to acquisition of the properties by the United States.

Sec. 4. Application for reimbursement or compensation under section 3 of this Act shall be submitted to the Commissioner within either one year from the date of acquisition or the date of vacating the premises by the applicant, whichever date is later. Applications not submitted within said period shall be forever barred.

Sec. 5. The Commissioner, in rendering an award in favor of any claimant under section 3 of this Act, may, as part of such award, determine and allow reasonable attorneys' fees which shall not exceed 10 per centum of the amount awarded, to be paid out of but not in addition to the amount of award, to the attorneys representing the claimant. Any attorney who charges, demands, receives, or collects for services rendered in connection with such claim any amount in excess of that allowed by the terms of this section, if award be made, shall be fined not more than $2,000 or imprisoned not more than one year, or both.

Sec. 6. Payments to be made is herein provided shall be in addition to, but not in duplication of, any payments that may otherwise be authorized by law. The means employed to acquire the property, whether by condemnation or otherwise, shall not affect eligibility for reimbursement or compensation under this Act. Nothing contained in this Act shall be construed as creating any legal right or cause of action against the United States or as precluding the exercise by the Government of the right of eminent domain or any other right or power that it may have under this or any other law; nor shall this Act be construed as precluding an owner or tenant from asserting any rights he may have under other laws or the Constitution of the United States.

Sec. 7. No amount received as an award under subsection a. and subsections b. (1) and (3) of section 3 of this Act shall be included

in gross income for purposes of chapter 1 of the Internal Revenue Code of 1954 (26 U.S.C. 1 et seq.). However, amounts received under subsection b. (1) shall be included in gross income to the extent that such amounts are not used within one year of the receipt thereof to purchase replacement housing or facilities.

SEC. 8. As used in this Act, the term "land" shall include interests in land, and the term "fair value" shall mean fair value of the interest acquired. The provisions of this Act shall be exempt from the operations of the Administrative Procedure Act of June 11, 1946 (60 Stat. 237), as amended (5 U.S.C. 1001–1011).

SEC. 9. There are authorized to be appropriated to the Department of State for the use of the United States section of said Commission not to exceed $44,900,000 to carry out the provisions of said convention and this Act and for transfer to other Federal agencies to accomplish by them or other proper agency relocation of their facilities necessitated by the project. Of the appropriations authorized by this section, not to exceed $4,200,000 may be used to carry out the provisions of section 3 of this Act. The provisions of section 103 of the American-Mexican Treaty Act of 1950 (22 U.S.C. 277d–3) are hereby expressly extended to apply to the carrying out of the provisions of said convention and this Act.

Approved April 29, 1964.

PART II

COMMITTEE AND CONFERENCE REPORTS

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PART II

COMMITTEE AND CONFERENCE REPORTS

[S. 1703][1]

EXTENSION OF MEXICAN FARM LABOR PROGRAM

[Senate Report No. 372, Eighty-eighth Congress, First Session, Calendar No. 347]

[July 22, 1963]

Mr. Mansfield (for Mr. Holland), from the Committee on Agriculture and Forestry, submitted the following report together with minority views to accompany S. 1703.

The Committee on Agriculture and Forestry, to whom was referred the bill (S. 1703), to amend title V of the Agricultural Act of 1949, as amended, and for other purposes, having considered the same, report thereon with a recommendation that it do pass with an amendment.

SHORT EXPLANATION

This bill would extend the Mexican farm labor program for 1 year, until December 31, 1964. The committee amendment merely corrects the designation of the section being amended.

HISTORY OF MEXICAN FARM LABOR PROGRAM

During World War II, and until 1951, Mexican workers were admitted into the United States for temporary employment in U.S. agriculture under various authorities, none of which were entirely satisfactory either to the workers, the employers, or the two Governments involved.

In 1951, the Congress approved Public Law 78 (82d Cong.) [C.B. 1951–2, 349], which added title V to the Agricultural Act of 1949. The major features of this legislation are as follows:

1. Authorizes the negotiation of an agreement with the Republic of Mexico establishing procedures for the admission of Mexican nationals into the United States for temporary employment.
2. Authorizes the Department of Labor to (*a*) undertake a recruitment and placement function with respect to such workers, (*b*) assist workers and farmers to enter into contracts for agricultural employment, and (*c*) guarantee the payment of wages and transportation by farmer employers.
3. Requires employers who wish to employ Mexican workers to (*a*) indemnify the U.S. Government for its guaranty of their contracts, (*b*) pay into a revolving fund a fee for each worker to support the program financially.
4. Restricts the use of Mexican workers to instances or areas where the Secretary of Labor certifies that (1) domestic workers, able, willing, and qualified are not available; (2) the employment of Mexican workers "will not adversely affect the wages and working conditions of domestic agricultural workers similarly employed"; and (3) reasonable efforts have been made to attract domestic workers at comparable wages, hours, and working conditions.
5. Eliminates bond requirement of general immigration statutes for such workers.

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[1] Public Law 88–203, page 5.

6. Provides that no such workers would be provided any employer who employs illegal aliens, either with knowledge or with reasonable grounds to believe they are here illegally.

7. Exempts such workers from social security and income tax provisions.

This statute has been implemented by an agreement with Mexico which sets forth in substantial detail the procedures, terms, and conditions of the contract of employment, and other matters.

Public Law 78 was scheduled to expire December 31, 1953. It has subsequently been extended on various occasions to December 31, 1955, June 30, 1959, June 30, 1961, December 31, 1961, and December 31, 1963.

The program is almost entirely self-supporting and will not burden our financial structure. Until 1947 the entire cost for importation of Mexican farm workers was borne by the U.S. Government. Today the user of such labor pays almost the entire costs of the program.

Under Public Law 78, the funds for payment of the expenses incurred in recruiting Mexican workers are met from the farm labor supply revolving fund. This fund reimburses the Department of Labor for expenses for transportation, food, and medical care from the time the Mexicans are accepted at migratory stations to the time they are contracted by employers and after their return to the reception center by employers upon the completion of the work contract. The fund also reimburses the Department for all other expenses incurred in the operation of this program, with the exception of compliance activities.

The fund is maintained by fees paid by employers for contracting Mexican workers. The maximum fee is $15 per worker for an initial contract and $15 for a recontract. In addition to this fee, the farmer must pay the cost of transporting the worker from the border to the place of employment and back again.

PROGRAM OBJECTIVE

The objective of this legislation has always been to provide workers to perform work generally called stoop labor, which is necessary to the cultivation and harvesting of many crops, but for which there are not sufficient domestic workers. There have always been a number of safeguards in the law to assure that workers will not be recruited under the program if domestic workers are available to do the work, or if such recruitment would adversely affect wages or working conditions of domestic workers. These safeguards were increased the last time the program was extended by (1) requiring that in addition to finding that the working conditions of domestic workers will not be adversely affected, the Secretary of Labor must find that reasonable efforts to attract domestic workers at comparable working conditions must have been made; (2) requiring that no workers recruited under the program may be used in other than temporary or seasonal employment, or to operate power-driven self-propelled harvesting, planting, or cultivating machinery, except in specific cases found necessary by the Secretary of Labor to prevent undue hardship; and (3) amending the definition of employment for which workers might be recruited to restrict it to fields in which large amounts of stoop labor are necessary.

NEED FOR A 1-YEAR EXTENSION OF THE PROGRAM

The Secretary of Labor has advised the Congress that areas of need for supplemental labor still exist, and has requested a 1-year extension of the program. His letter is attached hereto under the heading "Departmental Views." The Secretary has advised that the need for Mexican workers has decreased in recent years. Their peak employment reached 291,000 in 1959, but was only 114.200 in 1962. Overall contracting for them declined from a high of 445,200 in 1956 to 291,400 in 1961, and 195,000 in 1962. The mechanization of the cotton harvest and increased availability of domestic workers under the impetus of higher wage rates are credited by the Secretary for the decrease. The Secretary concludes that in spite of this trend there will be a definite need for foreign workers in the next year.

The Secretary also proposed amendments to the program to require employers to offer domestic workers occupational insurance coverage, housing, and transportation expenses comparable to those required to be furnished the Mexican workers.[2] This committee and Congress very carefully considered similar pro-

[2] While the Secretary refers in his letter to "transportation expenses" the draft bill submitted by him would have required the employers to make the transportation itself available.

posals in 1961 and, after thorough debate, agreed upon the additional safeguards described above. At that time this committee stated at page 5 of S. Rept. 619, 87th Congress [C.B. 1961–2, 452]:

> Section 2 of the bill amends clause (3) just quoted to include "working conditions" along with wages and standard hours of work. The term "working conditions" is intended by the committee to refer to the physical conditions under which the work is performed, such as those concerned with sanitation and safety, and not to include terms of employment such as housing, transportation, subsistence, insurance, and work guarantees. Mexican nationals enter this country under an international agreement in accordance with the terms of a standard work contract. They are not free agents in this country. Because of this, a responsibility to remain with the employer with whom they contract is imposed upon them. They do not bring their families with them. They enter this country to do a particular job after which they return home. Domestic workers, on the other hand, are free to come and go as they please. They may seek other employment in or out of agriculture if they wish. It is not intended, therefore, to require guarantees from farmers as to housing, payment of transportation, and periods of work for workers who may not fulfill their end of the bargain.

Substantially identical language was included at page 4 of the House statement of managers in the conference report, H. Rept. 1198, 87th Congress [C.B. 1961–2, 457]. The statement just quoted would appear to have greater applicability today than it did in 1961; and the wisdom of the action taken by Congress has been proved by subsequent events. The Secretary has advised the committee that there has been an increased availability of domestic workers, and that this is one of the two main reasons for the decrease in employment of Mexican workers recruited under the program. The Secretary has asked that the program be continued for only 1 additional year. With the program terminating next year, this does not appear to be the time to provide a whole new set of rules to be accompanied by the usual controversy and misunderstanding. And by the time it could be determined what is comparable housing, insurance, and transportation for domestic workers (who may be accompanied by their families) and appropriate regulations could be issued, there would be little time left to construct the required housing, procure the insurance, and arrange for the transportation. The idea of requiring the construction of housing which may not be occupied before the program ends does not appear wise to the committee, and the committee has therefore recommended a simple 1-year extension with no change.

DEPARTMENTAL VIEWS

U.S. Department of Labor,
Office of the Secretary,
Washington, March 26, 1963.

Hon. Lyndon B. Johnson,
President of the Senate,
Washington, D.C.

Dear Mr. President: I am enclosing copies of a draft bill to amend title V of the Agricultural Act of 1949, as amended, to provide protection for the employment opportunities of domestic agricultural workers in the United States, and for other purposes, and copies of an explanatory statement describing the proposed legislation.

The draft bill would extend the program under which the Secretary of Labor is authorized to recruit workers from Mexico for agricultural employment in the United States for 1 year—until December 31, 1964. While areas of need for supplemental farm labor still exist, the overall uncertainty of the employment situation and developments in the program itself make it desirable for the administration and Congress to have the early opportunity to make a further review of the program.

The draft bill would also amend the program by requiring employers who seek to obtain Mexican workers to offer domestic workers workmen's compensation or occupational insurance coverage, housing, and transportation expenses comparable to those required to be furnished the Mexican workers. Employers are required to provide these benefits as well as others to the Mexicans under the international agreement with the Republic of Mexico. The amendment would

not require employers to undergo as much expense to obtain domestic workers as they do in obtaining Mexican workers. Its purpose is to extend available job opportunities to domestic workers without imposing any onerous burden upon agricultural employers.

The Bureau of the Budget has advised that there is no objection to the presentation of this draft bill from the standpoint of the administration's program.

Yours sincerely,

W. WILLARD WIRTZ,
Secretary of Labor.

MINORITY VIEWS, S. 1703

Public Law 78, the Mexican farm labor program, was enacted in 1951 as a temporary program to meet a special need for agricultural laborers at the time of the Korean conflict. It was scheduled to end on December 31, 1953, but it has been extended several times: to December 31, 1955, to June 30, 1959, to June 30, 1961, to December 31, 1961, and to December 31, 1963.

For several years Public Law 78 has been strongly opposed by many civic, religious, and labor groups because of its adverse economic and social effects on domestic migratory workers.

The Department of Labor under both the Eisenhower and Kennedy administrations opposed extension unless substantial changes were made to safeguard the rights of domestic workers.

In 1961 the Senate adopted an amendment to provide a practical test to assure that the program would not be used to depress the wages of domestic workers. This provision was eliminated by the conference committee and only minor reforms were achieved.

Earlier this year the House of Representatives by a vote of 174 to 158 rejected a bill to extend Public Law 78 for 2 more years, and unless further action is taken, the program will end on December 31, 1963.

S. 1703 would extend the Mexican farm labor program for 1 more year.

No hearings have been held by the committee on S. 1703 and no departmental reports on it have been received. In March, before the action by the House, the Department of Labor did submit a draft bill to extend the program for 1 year, but the draft bill also included a major amendment to protect the rights of domestic workers. The Department recommendation would require employers who seek Mexican nationals to offer domestic workers housing, transportation expenses, and occupational insurance comparable to that which such employers must furnish Mexican workers under the international agreement. S. 1703 does not contain this provision. We do not believe that action to extend this program should be taken until the Secretary of Labor has expressed his views regarding an extension which fails to include the Department's amendment to provide somewhat comparable benefits to domestic workers.

We believe that the many civic, religious, and other groups which have long had a deep concern about the welfare of migratory workers should have a chance to present their views and recommendations.

We believe that the serious questions raised by this program in the past require clear and definite answers in the light of the experience of the past 2 years before any extension is approved. Among the many factors which require careful consideration are the following:

1. Persistent and high rates of unemployment and underemployment. The national rate of unemployment has averaged more than 5.5 percent for the past 2 years, and the rate for hired farmworkers, who are particularly vulnerable to seasonal unemployment, is even higher. Moreover, mechanization in agriculture continues to reduce employment opportunities for farmworkers. The number of hired farmworkers in 1962 averaged 4 percent less than in 1961 and the number of family farmworkers was down 3 percent in 1962. These and other figures indicate that the need in farm and rural communities is for more employment opportunities, not for importing workers from other nations. Undoubtedly there is need for a better system of recruitment of domestic migratory workers to provide the needed labor for seasonal crops, and a bill to provide a voluntary recruitment program for agricultural workers has been introduced in the Senate.

2. Low income of migratory farmworkers. Farmworkers generally are not covered by provisions of the Fair Labor Standards Act nor by the minimum wage or other protective legislation of most of the States. Secretary of Labor Willard

Wirtz recently stated that in 1961 migratory farmworkers "earned on an average less than $900 from all employment." The number of hired farmworkers averaged 1,817,000 persons in 1962. It is not possible to contract or recontract some 225,000 Mexican nationals without having a significant effect on the wages of these domestic farmworkers.

3. Will American citizens do stoop labor? One of the principal arguments for the Mexican farm labor program over the years has been that U.S. citizens will not perform stoop labor. American citizens have a record of performing all types of work when the compensation is adequate for the skills and risks involved. The type of work done by braceros in limited areas is, in fact, performed by American citizens in other sections of the Nation. The Mexican farm labor program serves less than 1 percent of the American farmers. In 1962 only 33,214 farms in the Nation used braceros. California alone accounted for 53 percent of the total man-months of Mexican labor in 1962 and Texas for another 26 percent; most of the remaining Mexican labor was confined to farms in the four additional States of Arizona, Arkansas, Michigan, and Colorado. The majority of family farm operators in the United States use no hired farm labor at all.

Our migratory workers are among the most neglected and underprivileged groups in the Nation. The Senate has recently passed several bills aimed at improving the conditions of these migratory workers. These are useful steps in meeting the serious problems of these citizens. But the basic difficulties of our domestic migratory workers have been extended and intensified by the effects of the annual importation of tens of thousands of Mexican nationals. Without adequate provision to check the adverse effect of this program on the employment opportunities, wages, hours, and working conditions of domestic workers, we do not believe that Public Law 78 should be extended, as provided in S. 1703.

William Proxmire,
Eugene McCarthy,
Maurine Neuberger,
George McGovern.

740-258 O—64——9

REVENUE ACT OF 1964

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[H.R. 8363][1]

REVENUE ACT OF 1964

[House of Representatives Report No. 749, Eighty-eighth Congress, First Session]

[September 13, 1963]

SEPTEMBER 13, 1963.—Commited to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. MILLS, from the Committee on Ways and Means, submitted the following report to accompany H.R. 8363.

The Committee on Ways and Means, to whom was referred the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

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[1] Public Law 88–272, page 6, this Bulletin.

I. SUMMARY

This bill, H.R. 8363, provides the largest tax reduction ever reported by your committee. In addition, it represents the second major revision of the Federal tax system reported by your committee in a 2-year period.

As indicated by part II of this report, the principal purpose of this bill is to lower tax rates so that our free enterprise system can itself generate the higher rate of growth which our economy requires. The purpose of this bill also is to improve the equity of the tax laws by removing or altering features of the tax provisions which are generally considered to be unfair and by meeting certain hardships which exist under the present structure.

(a) Revenue impact.—This bill over a 2-year period is expected to reduce tax liabilities by $11.1 billion—$2.3 billion of corporate and $8.8 billion of individual tax liabilities. In the fiscal year 1964 this is expected to result in a revenue reduction of $2.2 billion and in the fiscal year 1965 a reduction of $7.4 billion (including the $2.2 billion reduction in 1964). This is without regard to any stimulative effect these reductions may have. Taking into account the Treasury Department's estimate of the stimulative effect, the bill is expected to reduce revenues by $1.8 billion in the fiscal year 1964 and by $3.5 billion in the fiscal year 1965. Further details on revenue estimates are shown in part III of this report.

(b) Study of proposals.—On January 24, 1963, the President sent to Congress a message containing his proposals for tax rate reductions for both individuals and corporations as well as a series of proposals for the revision of the present tax laws. Your committee on February 6, 1963, began hearings on the President's proposals. The hearings lasted until March 27 and included 27 days on which your committee heard testimony; this material is contained in 7 volumes of over 4,000 pages. Following the public hearings, your committee studied the President's proposals in executive sessions over a period of many weeks, reaching tentative decisions for incorporation in a draft bill. After the preparation of a bill incorporating these tentative decisions, your committee again reviewed this tentative bill, making such modifications as they deemed appropriate. The bill as modified has been reported by your committee.

(c) Rate reductions.—Under this bill individual income tax rates are reduced, from the present rates of 20 to 91 percent, to rates ranging from 14 to 70 percent in 1965. Rates ranging from 16 to 77 percent make about two-thirds of this reduction available for 1964. Closely related to the individual income tax rate reduction is the minimum standard deduction provided by the bill which, in effect, when coupled with personal exemptions, sets an income floor. Individuals with income levels below the specified amounts will have no income tax payments to make.

The tax rate for corporations in 1964 is reduced from 52 to 50 percent and is further reduced in 1965 to 48 percent. In addition, the rate

applicable to the first $25,000 of corporate income beginning in 1964 is reduced from 30 percent to 22 percent. Furthermore, corporations are placed on a full pay-as-you-go basis so that ultimately all of their tax liability above $100,000 is to be payable in the year in which it is earned. This is achieved over a 7-year period so that it will not increase corporate tax payments in the transitional period. Further details with respect to these changes are presented in part IV A below.

(d) Structural changes.—In addition to the rate changes referred to above, your committee's bill includes 23 sections providing structural changes in the tax laws. For an explanation of these provisions, see part IV B of the report. The following represents a thumbnail sketch of these structural changes:

1. ***Dividend credit and exclusion.***—The 4-percent dividend received credit is reduced by the bill to 2 percent for 1964, and repealed for subsequent years. The $50-dividend exclusion is increased to $100 (usually $200 in the case of married couples) for 1964 and subsequent years.

2. ***Investment credit.***—In the case of the investment credit, the bill (*a*) repeals the provision requiring a 7-percent downward adjustment in the basis of property eligible for depreciation to the extent that the investment credit applies; (*b*) prevents regulatory commissions in certain cases from requiring the "flow through" of the benefits of the investment credit to the customers of regulated industries; and (*c*) makes other revisions in the investment credit.

3. ***Group term insurance.***—The bill limits the employee exclusion for premiums on group term insurance furnished through the employer to premiums paid for the first $30,000 of coverage; it also provides a special deduction for employees who are in effect paying part of someone else's insurance costs in the case of coverage above $30,000.

4. ***Reimbursed medical expenses.***—The bill includes, in gross income, reimbursed medical expenses to the extent the reimbursement exceeds the actual medical expenses incurred with respect to the illness or accident.

5. ***Sick pay exclusion.***—The bill restricts the sick pay exclusion, of up to $100 a week, to those who are out of work for more than 30 days (and makes the exclusion available only for the period beyond that time).

6. ***Sale of residence by aged taxpayer.***—The bill provides an exclusion from the tax base for the gain on up to $20,000 of the sales price of a personal residence in the case of an individual aged 65 or over.

7. ***Deduction of certain State and local taxes.***—The bill denies a deduction in computing income subject to Federal tax for State and local taxes other than property, income, and general sales taxes (the principal taxes for which a deduction is denied are gasoline, auto license, alcoholic beverage, cigarette, and selected excise taxes).

8. ***Casualty loss deduction.***—The deduction for personal casualty and theft losses is limited to the amount in excess of $100 per loss (similar to "$100 deductible" insurance).

9. ***Charitable contribution deduction.***—Several changes are made in the charitable contribution deduction: (*a*) The 30-percent maximum deduction is made available generally for contributions to organizations other than private foundations; (*b*) the 2-year carryover

of charitable contributions for corporations is extended to 5 years; and (*c*) charitable contributions deductions for future interests in tangible personal property are denied until the gifts are completed except where the property is retained for the life or lives of the donor or donors.

10. ***Medical expense deduction.***—The 1-percent limitation, or floor, on medicines and drugs which must be taken into account in determining deductible medical expenses is made inapplicable where the taxpayer and his wife are over 65 and also to their parents where they are over 65.

11. ***Child-care expense deduction.***—The child-care deduction is revised: (*a*) to make it available in the case of a wife who is "institutionalized" or "incapacitated"; (*b*) to make it available with respect to care for children up to age 13 (instead of 12); and (*c*) the maximum deduction allowable where there are two or more children is increased from $600 to $900.

12. ***Moving expense deduction.***—A deduction for certain moving expenses—transportation of the household goods and the persons involved, and also their meals and lodging while in transit—is allowed for employees who are not reimbursed for these expenses and also for new employees (an exclusion for these items is already available in the case of old employees who are reimbursed).

13. ***"Bank loan" insurance.***—An interest deduction is denied for amounts borrowed under a systematic plan to pay premiums on life insurance (certain exceptions are provided).

14. ***Stock options.***—The present tax treatment of employee stock options is further restricted, the principal additional restrictions being that (*a*) the stock when acquired must be held for 3 years or more; (*b*) the option must not be for a period of more than 5 years; (*c*) the option price must at least equal the market price of the stock when issued; (*d*) stockholders' approval for the options must be obtained; and (*e*) the extent to which new options may be exercised when the old options are outstanding is restricted. Separate tax treatment is provided for employee stock purchase plans which are available to all employees on a nondiscriminatory basis under rules which are substantially the same as under present law.

15. ***Interest on certain deferred payments.***—Where property is sold on an installment basis and either no, or very low, interest is charged on the installments, the bill provides that an appropriate amount of each installment is to be treated as if it were an interest payment.

16. ***Personal holding companies.***—The tax treatment of personal holding companies is made considerably more restrictive. For example, the percentage of passive income which may result in a company being classified as a personal holding company is reduced from 80 to 60 percent and amendments are made so that the tax cannot be avoided by using rental or oil or gas or mineral royalties (or working interests) to shelter substantial amounts of investment income, such as dividends and interest, from the personal holding company tax. A number of other restrictive amendments are also made. On the other hand, relief is provided for those companies which are not now personal holding companies, but which would be under the new definitions. They are permitted favorable liquidation treatment in certain cases and also permitted a deduction, in computing the personal

holding company income, for paying off existing debts. An amendment is also added relating to foreign personal holding companies permitting an increase in the basis of the stock of such a company at the time of the shareholder's death for death taxes attributable to the appreciation in such stock. A similar increase in basis is allowed in the case of property representing distributions from such a company, under certain conditions.

17. ***Aggregation of oil and gas properties.***—For the future, oil and gas leases or acquisitions are no longer to be aggregated in determining what constitutes a property for purposes of computing the percentage depletion deduction.

18. ***Iron ore royalties.***—The bill provides capital gains treatment for iron ore royalty payments.

19. ***Taxation of capital gains.***—The present capital gains treatment for individuals is revised by the bill so that in the case of most assets held more than 2 years, 40 percent (rather than 50 percent) of the gain will be included in the tax base and the alternative rate of tax on this is to be 21 percent (rather than 25 percent). Certain types of income given capital gains treatment today which are not actually capital gains will continue to be treated as they are today (50 percent inclusion or 25 percent alternative rate). The bill also provides an unlimited (instead of 5-year) carryover of capital losses in the case of individuals.

20. ***Sale of depreciable real estate.***—In the case of real estate sold at a gain in the future, depreciation deductions, generally to the extent these deductions exceed depreciation allowable under the "straight line" method (to the extent of the gain), will be treated by the bill as giving rise to ordinary income. However, in the case of property held more than 20 months the amount treated as ordinary income will be reduced by 1 percent for each month of holding over 20, with the result that no amount will be treated as ordinary income in the case of real property held more than 10 years.

21. ***Averaging of income.***—The bill in effect provides for the averaging of income over a 5-year period where the income in the current year exceeds the average of the 4 prior years by more than one-third and this excess equals at least $3,000.

22. ***Repeal of consolidated returns tax.***—The 2-percent penalty tax, which must presently be paid by corporations for the privilege of filing consolidated returns, is repealed.

23. ***Multiple surtax exemption.***—For corporations where there is common control to the extent of 80 percent or more, the corporations involved generally are limited to one $25,000 surtax exemption for the group or alternatively required to pay a special tax of 6 percent on the first $25,000 of their income. No penalty tax is imposed where a consolidated return is filed for the group.

II. REASONS FOR BILL

The principal purpose of the revenue bill of 1963 is to remove from the private sector of the American economy its present high-tax strait-jacket; that is, to lessen restraints which prevent the American free-enterprise system from itself generating necessary growth. A purpose of this bill also is to improve the equity of the tax laws; that is, to remove features of the tax code which generally are considered to be unfair and to revise others to remove inequities. Thus, it is intended that the influence of tax provisions on business decisions be minimized.

(*a*) *Lowering of tax rates.*—With the present high tax encumbrances imposed upon our economy it would be difficult, if not impossible, to achieve the economic expansion necessary to provide a fully employed economy. It is to meet these problems that this bill undertakes a major lowering of tax burdens on both individuals and the business community. For individuals this is the largest tax rate reduction of all time—a rate reduction of nearly $9.5 billion, or an average reduction in individual tax rates of 20 percent. For corporations this is a reduction of $2.2 billion, or when coupled with the investment credit reduction and depreciation reforms provided last year, a reduction of approximately $4.5 billion.

The present individual income tax rate pattern was established during World War II when some of the objectives of the rate structure were quite different from what they are today. At that time the rates were made steeply progressive in the upper brackets to assure equality of sacrifice. At the same time, heavy rates were imposed at the lower end of the rate structure, both because of the need for revenue and also because it was intended that these rates have a dampening effect on consumer purchasing. Today it is essential that the rate structure not inhibit initiative on the part of individuals, either as employees or as managers or owners of business. It is especially important that the youth of the country have both the opportunity and the incentive to devote their full talents, abilities, and energies to the building of a stronger society. Moreover, today, with our unused plant capacity and underemployment, we cannot justify the continuance of these tax rates which encourage operation at less than full capacity. Instead we need rates which will not place a brake on investments and consumer purchases.

(*b*) *Increasing revenues.*—As indicated by the first section of this bill, it is your committee's opinion that this bill will stimulate the economy, and—after a brief transitional period—raise revenues, rather than lower them. Moreover, it is intended that the additional revenues resulting from this bill be used first to eliminate the deficits which have been consistently plaguing the Federal Government's budget for an extended period of time, and then to reduce the public debt.

It is recognized that to many it may seem inconsistent to think of cutting taxes as a way of increasing revenues. Nevertheless, past

experience demonstrates that this can happen; in fact, given today's conditions it can be expected to happen. The events of the period 1954-56 demonstrate how this can occur. In 1954 Congress allowed the individual income tax increases imposed during the Korean war to expire, made certain excise tax reductions, allowed the excess profits tax to expire and made certain other tax reductions as well. The total of these reductions amounted to about $7.4 billion. Yet, only 2 years later, in 1956, receipts were $3.2 billion above the level existing before the reductions were made. However, these reductions did not get to the root of the matter, the high World War II rates, with the result that the poor economic performance of the economy since 1956 has left a heavy mark on the Federal debt. The initial budget forecast for each of the fiscal years 1958 to 1963 was for a budgetary surplus. The actual outcome in 5 of the 6 years, however, was a deficit, averaging over $6 billion a year. The major factor accounting for each of these deficits was the failure of the economy to expand as anticipated.

Your committee's bill will stimulate the economy both by improving the environment for investment and also by increasing consumer purchasing power.

The environment for business investment is improved by the 4-percentage-point corporate tax rate reduction and the 8-percentage-point drop in the rate applicable to small business. This becomes especially significant when added to the investment credit and depreciation rate reform provided last year, which, taken together with the rate reduction, mean an aggregate reduction of approximately $4.5 billion. Additional factors improving the environment for business investment and providing more funds for investment, are the reduced individual income tax rate in the middle and upper income rate brackets, together with the increased demand for the products of business stemming from the increased consumer purchasing power provided by the bill. Increased consumer purchasing power is added primarily by the individual income tax rate reductions, particularly those in the lower brackets, and also by the minimum standard deduction. In this respect, the 38-percent reduction for adjusted gross incomes of $3,000 and less is particularly important.

The reduction in individual income tax rates provided by this bill, in addition to the incentive effect, also will have an important stimulative effect on the economy in that it will leave income with consumers which presently is taken from them in taxes. Based upon normal consumer spending habits, it can be anticipated that 92 to 94 percent of this additional income left in the hands of consumers will be spent on consumer goods and services. This will result in further income which in turn will generate still further rounds of increased consumer expenditures. In addition, the bill can be expected to substantially increase expenditures by business for items such as plant and equipment and inventory. This increased investment on the part of business can be expected also to add income to the pockets of consumers and this also will lead to further rounds of increased consumer spending. Moreover, the additional consumption expenditures made possible by this bill can also be expected to further increase the demand for products leading to further investment expenditures to provide the plant, equipment and inventory these expenditures make necessary.

It is on this basis that the Treasury Department has indicated to your committee that the reduced rates provided by this bill will generate sufficient additional income so that with the resulting enlargement in revenues it is to be expected that the Federal Government's budget can be balanced sooner than would be the case in the absence of a tax cut.

(c) *Expenditure control.*—Your committee recognizes, however, that if Congress is to provide the tax reductions included in this bill a tighter rein than previously must be kept on expenditures. Moreover, the effect of the tax reduction provided by this bill in raising the level of economic activity and in reducing unemployment and idle men and plant and equipment is a complete answer to the argument offered by some for increasing Government expenditures in order to overcome unemployment. If a solution to unemployment and related problems is to be sought by tax reduction, it is all the more important for Government expenditures to be brought more closely under control than in the past. There certainly can be no argument in such a case for undertaking new Government programs which are not in and of themselves essential, merely because they might contribute to Government spending. By the same token, the principles of good fiscal management make it all the more important to shun wastefulness in Government expenditure programs under these conditions. It was for these reasons that your committee in section 1 of the bill states:

> To further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

In this regard, it should be noted that the President, in a recent letter (shown in full in Part V. Appendix) to your committee's chairman, states:

> First, our long-range goal remains a balanced budget in a balanced full-employment economy. It is clear that this goal cannot be achieved without a substantial tax reduction and the greater national income it will produce.
>
> Second, tax reduction must also, therefore, be accompanied by the exercise of an even tighter rein on Federal expenditures, limiting outlays to only those expenditures which meet strict criteria of national need.
>
> Third, consistent with these policies, as the tax cut becomes fully effective and the economy climbs toward full employment, a substantial part of the increased tax revenues will be applied toward a reduction in the transitional deficits which accompany the initial cut in tax rates.
>
> Fourth, assuming enactment of the tax program incorporated in your committee's bill with a consequent loss of revenue of $5 billion more in fiscal 1965 than in fiscal 1964, I nevertheless expect—in strict accordance with the above policies, and in the absence of any unforeseen slowdown in the economy or any serious international contingency for the next 5 months—to be able to submit next January a budget for 1965 involving an estimated deficit of less than

the $9.2 billion forecast for fiscal 1964 by the Secretary of the Treasury in your executive sessions last week.

Thus, the President committed himself to preventing expenditure increases from exhausting the additional revenue which arises as the economy expands under the impetus generated by the tax reduction.

It should be noted that there already have been significant achievements in reducing the governmental deficit through economical management. The deficit of $8.8 billion predicted last January for the fiscal year 1963 was held down to $6.2 billion through improved tax receipts, increased sale of Government-held financial assets, and economies in the expenditure programs. In addition, the Secretary of the Treasury recently told your committee that the deficit for the current fiscal year now is expected to be about $9.2 billion, assuming the passage of this bill. This is nearly $3 billion below the budget forecast of this last January.

Your committee believes, however, that a greater effort needs to be made, both by the executive departments and by Congress, in holding down Government spending. When Congress reduces the revenues for the highly desirable purpose of bringing the tax rates down, all of us recognize that there is implicit in this action the need to screen with meticulous care all requests for authorizations and expenditures of funds—for top priority cannot be given both to tax reductions and to spending at the same time. It is for this reason that in section 1 of this bill Congress is asked by this action to recognize the importance of taking all reasonable means to restrain Government spending and to urge the President to declare his accord with this objective. Your committee firmly believes that Government spending can be so restrained in view of the importance which is so widely attached to the desirability of obtaining a tax reduction at this time.

(*d*) *The problem of unemployment.*—Balancing the budget is only one of the major national objectives with which this bill is concerned. The same growth in the economy which this bill provides as a means of balancing the budget will at the same time reduce unemployment. Unemployment has amounted to 5 percent or more of the labor force for every month for more than 5 years and has on several occasions been close to 7 percent. Currently, the unemployment rate is 5.5 percent. The unemployment rate for several recent years is as follows:

	Percent
1954	5. 6
1956	4. 2
1958	6. 8
1960	5. 6
1961	6. 7
1962	5. 6
1963 (6 months seasonally adjusted)	5. 8

In large part, this unemployment stems from a lack of sufficient growth in the economy. It is recognized, of course, that structural unemployment may also be a factor in the size of the unemployed. However, your committee's bill by providing greater opportunity for growth in the private sector of the economy will increase the incentives of private business to provide retraining programs and to search out those in other locations who may fill their employment needs.

The upsurge which is sure to occur in the size of the labor force in the years immediately ahead makes this problem all the more sig-

nificant. To achieve full employment between now and 1966, 5.5 million new jobs would have to be created, in addition to providing the jobs necessary to reemploy those displaced by automation or changing markets. Maintaining the 3-percent rate of growth as the United States has done since 1956, not only will fail to eliminate the present excessive unemployment, but unemployment will continue to rise as the increasing numbers of children born during the war and early postwar years reach employment age. The faster rate of growth which this bill will provide must play a key role in meeting this problem.

(e) *Unused plant and equipment capacity.*—Closely related to the problem of excessive unemployment has been the problem of excessive unused plant and equipment capacity. The rate of operation for all manufacturing for selected recent years according to the McGraw Hill survey is as follows:

	Percent		*Percent*
1954	84	1960	77
1955	92	1962	83
1957	78	Preferred rate of operation for 1962	92
1959	85		

This problem of excess capacity has plagued American industry since 1957, the same period during which plant and equipment investment have lagged, despite the growth in the economy. For example, business expenditures on new plant and equipment has fallen from 8.3 percent of the gross national product in 1956–57 to 6.7 percent in 1962. Unused capacity in plant and equipment is largely attributable to the absence of two factors: adequate profit margins and a sufficient demand for goods and services. The stimulation provided by this bill for investment, both directly through lower rates of tax on business—and therefore higher profit rates after tax—and also indirectly through increased purchasing power—which will increase the demand for goods and services—will aid in raising the level of investment, in the same manner as it aids in reducing unemployment.

(f) *Balance-of-payments problem.*—The tax reduction provided by this bill is also needed to help in reducing the persistent balance-of-payments deficit. As President Kennedy recently stated, tax reduction and revision "is the single most important step that can be taken to achieve balance abroad as well as growth here at home." Poor domestic growth stifles productivity and inhibits the introduction of new products that can compete effectively in export markets. It also reduces domestic investment opportunities compared with those abroad. These conditions which have worked against the elimination of the payments deficit will be substantially improved by the tax program incorporated in your committee's bill.

While the increased incomes stemming from the tax reduction may also tend to increase somewhat the demand for imports, the effect of the tax cut on exports and on making domestic investments more attractive can be expected to outweigh the higher demand for imports. Experience in Europe, where rapidly growing and modernizing economies have produced balance-of-payment surpluses, confirms the fact that a healthy domestic economy, attractive to foreign and domestic capital, and capable of increasing productivity, can reinforce the external strength of the currency.

(*g*) *The bill is not inflationary.*—While this bill will increase the demand for the products of American business, it will not lead to inflation. As indicated above, the U.S. economy now has substantial unused resources, both of labor and plant capacity. These resources are sufficient to meet the increased demand to be expected from the tax reductions made by this bill, with increased output and without inducing any price spiral. This is well demonstrated by recent experience. Despite increases in consumer demand in 1959 and 1960 and again in late 1961 and 1962, since 1957 there has been a period of unusual price stability. The wholesale price index for manufactured goods is virtually unchanged from 5 years ago, while the consumer price index has increased on the average only about 1 percent a year since 1958.

Any lingering doubt that there might be as to any inflationary impact of this bill should be dissipated by the fact that the tax reduction provided by your committee's bill—both the individual and corporate reductions—is spread over 2 years, rather than being concentrated in a single year. This provides an opportunity to gear up for the increased demand in any areas where the labor and plant capacity may not already be available.

(*h*) *Impact of structural changes.*—While much of the above discussion has been based upon the incentive aspect of the tax rate reductions provided by this bill, the structural changes as well can be expected to have a salutary effect. First, revenue increasing measures provide $1.1 billion of additional tax liability which make it possible to provide $320 million for a minimum standard deduction and $165 million for other structural improvements, while leaving $595 million which was used to provide further reductions in the marginal tax rates than could otherwise be made. The revision in the area of capital gains taxation also will contribute to new investment and economic growth. The lower 40-percent inclusion factor provided for gains from the sale or exchange of capital assets held over 2 years will be a major factor in providing a stimulus to the economy.

The structural changes are probably more important, however, in improving the equity of the tax laws. Only if the notion is generally held that the tax burden is distributed fairly can it be expected that individuals and the business community will be willing to bear the tax burdens which our defense requirements makes necessary today. The present tax bill, supplements the significant strides made by Congress last year in improving the confidence of the American people in the fairness of the present tax system.

III. REVENUE ESTIMATES

The revenue effect of your committee's bill is shown in tables 1 through 4 below. Tables 1 and 2 are based on income levels estimated for the calendar year 1963 but do not take into account any "feedback" to the economy anticipated from this bill. Table 1 shows the estimated impact of the various provisions contained in your committee's bill upon calendar year 1964 and 1965 tax liabilities. Table 2 shows the estimated effect of your committee's bill upon receipts in the fiscal years 1964 and 1965.

Table 1 indicates that your committee's bill can be expected to decrease calendar year 1964 tax liabilities by slightly over $7 billion and calendar year 1965 liabilities by slightly over $11 billion (the latter figure includes the $7 billion reduction). To a substantial degree, the calendar year 1965 effect represents the long-term effect of the bill before taking into account any impact of the reductions upon the economy. Of the $11 billion reduction in 1965, $8.8 billion will go to individuals, or nearly 80 percent of the total. Revenue raising structural changes for the calendar year 1965 amount to slightly over $1 billion but are partially offset by other liberalizing provisions reducing the net increase to $595 million.

TABLE 1.—*Estimated decrease (−) and increase (+) (before feedback) of tax liabilites [1] for the calendar years 1964 and 1965 as a result of the provisions of your committee's bill*

[In millions of dollars]

	Calendar year 1964			Calendar year 1965		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program:						
Rate changes	−6,310	−1,320	−7,630	−9,470	−2,190	−11,660
Structural changes:						
(a) Revenue raising:						
1. Group term insurance	+5		+5	+5		+5
2. Bank loan insurance	+5		+5	+5		+5
3. Sick pay exclusion	+110		+110	+110		+110
4. Deduction of personal taxes	+520		+520	+520		+520
5. Casualty loss deduction	+50		+50	+50		+50
6. Aggregation of mineral properties		+40	+40		+40	+40
7. Personal holding companies	+15		+15	+15		+15
8. Repeal of dividend credit and increase in exclusion	+120		+120	+300		+300
9. Multiple corporation penalty tax		+35	+35		+35	+35
10. Gifts of future interest	(2)		(2)	(2)		(2)
Total, revenue raising	+825	+75	+900	+1,005	+75	+1,080

See footnotes at end of table.

TABLE 1.—*Estimated decrease (—) and increase (+) (before feedba k) of tax liabilites [1] for the calendar years 1964 and 1965 as a result of the provisions [2] of your your committee's bill*—Continued

[In millions of dollars]

	Calendar year 1964			Calendar year 1965 [1]		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program—Continued						
Structural changes—Continued						
(b) Revenue reducing:						
11. Medical expense deduction	−10		−10	−10		−10
12. Child care allowance	−5		−5	−5		−5
13. Moving expenses	−60		−60	−60		−60
14. Income averaging	−40		−40	−40		−40
15. Minimum standard deduction	−320		−320	−320		−320
16. Repeal 2-percent tax on consolidated returns		−50	−50		−50	−50
17. Charitable deductions	(2)		(2)	(2)		(2)
Total, revenue reducing	−435	−50	−485	−435	−50	−485
Total, structural changes	+390	+25	+415	+570	+25	+595
Total, rate and structural changes, 1963 tax program	−5,920	−1,295	−7,215	−8,900	−2,165	−11,065
Capital gains revision (including induced effects):						
1. 50- to 40-percent inclusion	+340		+340	+210		+210
2. Sale or exchange of real estate		(2)	(2)		+5	+5
3. Carryover of losses	−30		−30	−30		−30
4. Sales of residences by taxpayers aged 65 or over	−10		−10	−10		−10
5. Capital gains treatment of iron ore royalties		−5	−5		−5	−5
6. Stock options	(2)		(2)	(2)		(2)
Total, capital gains revision	+300	−5	+295	+170	0	+170
Total, 1963 tax program	−5,620	−1,300	−6,920	−8,730	−2,165	−10,895
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit	−20	−125	−145	−25	−160	−185
2. Allow investment credit for elevators and escalators		−10	−10		−10	−10
Total, revision of 1962 legislation	−20	−135	−155	−25	−170	−195
C. Total	−5,640	−1,435	−7,075	−8,755	−2,335	−11,090

[1] At levels of income estimated for the calendar year 1963.
[2] Less than $2.5 million.

Table 2 shows that your committee's bill will decrease revenues in the fiscal year 1964 by $2.2 billion and in the fiscal year 1965 by $7.4 billion (the latter figure includes the $2.2 billion reductien). These figures are considerably lower than the calendar year liability figures for the same year; first, because of the fact that the fiscal year ends in the middle of the calendar year; and, second, because the calendar year data are shown on the basis of liability rather than receipts. Liabilities indicate the amount of tax liability attributable to income of the

year in which it is earned; receipts show the actual amount collected in the year in question. Since collection tends to lag behind the accruing of the liability, tax reductions show up in later years when shown on a "receipt" basis than when shown on a "liability" basis.

It is important to note that it is not expected that actual tax revenues in the fiscal year 1964 and future years will be reduced by the full $2.2 or $7.4 billion referred to above. It is anticipated that income levels in these years will be substantially higher as a result of the economic stimulus of the tax cut and will generate revenues significantly offsetting the budgetary impact of these rate reductions.

TABLE 2.—*Estimated decrease* [1] (−) *and increase* (+) (*before feedback*) *of tax receipts for the fiscal years 1964 and 1965 resulting from your committee's bill*

[In millions of dollars]

	Fiscal year 1964			Fiscal year 1965		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program:						
Rate changes	−2,430		−2,430	−7,530	−1,320	−8,850
Acceleration of payments		+260	+260		+900	+900
Total	−2,430	+260	−2,170	−7,530	−420	−7,950
Structural changes:						
(*a*) Revenue raising:						
1. Group term insurance				+5		+5
2. Bank loan insurance				+5		+5
3. Sick pay exclusion				+110		+110
4. Deduction of personal taxes				+520		+520
5. Casualty loss deduction				+50		+50
6. Aggregation of mineral properties					+40	+40
7. Personal holding companies				+15		+15
8. Repeal of dividend credit and increase in exclusion				+120		+120
9. Multiple corporation penalty tax					+35	+35
10. Gifts of future interest				([2])		([2])
Total, revenue raising				+825	+75	+900
(*b*) Revenue reducing:						
11. Medical expense deduction				−10		−10
12. Child care allowance				−5		−5
13. Moving expenses				−60		−60
14. Income averaging				−40		−40
15. Minimum standard deduction				−320		−320
16. Repeal 2-percent tax on consolidated returns					−50	−50
17. Charitable deductions				([2])		([2])
Total, revenue reducing				−435	−50	−485
Total, structural changes				+390	+25	+415
Total rate and structural changes, 1963 tax program	−2,430	+260	−2,170	−7,140	−395	−7,535
Capital gains revision (including induced effects):						
1. 50 to 40 percent inclusion				+340		+340
2. Sale or exchange of real estate					([2])	([2])
3. Carryover of losses				−30		−30
4. Sales of residences by taxpayers aged 65 or over				−10		−10

See footnotes at end of table, p. 15.

TABLE 2.—*Estimated decrease*[1] (−) *and increase* (+) (*before feedback*) *of tax receipts for the fiscal years 1964 and 1965 resulting from your committee's bill*—Continued

[In millions of dollars]

	Fiscal year 1964			Fiscal year 1965		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program—Continued						
Capital gains revision (including induced effects)—Continued						
5. Capital gains treatment of iron ore royalties					−5	−5
6. Stock options				(2)		(2)
Total, capital gains revision				+300	−5	+295
Total, 1963 tax program	−2,430	+260	−2,170	−6,840	−400	−7,240
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit		−15	−15	−20	−125	−145
2. Allowing investment credit for elevators and escalators		−5	−5		−10	−10
Total, revision of 1962 legislation		−20	−20	−20	−135	−155
C. Total	−2,430	+240	−2,190	−6,860	−535	−7,395

[1] At levels of income estimated for the calendar year 1963.
[2] Less than $2,500,000.

The stimulative effects of the tax reduction are expected to produce, according to the Treasury Department, relatively modest amounts of increased income in the first months, with the result that the "feedback" effect on the fiscal year 1964 revenues is expected to amount to only $400 million. As a result, the gross tax loss of $2.2 billion for the fiscal year 1964 is expected to be reduced to $1.8 billion after the "feedback" effect. The Treasury Department has estimated that the increased revenues from the rise of income, however, will amount to about $4 billion in the fiscal year 1965. Thus, the Treasury estimates that while reduced tax rates during that year would lose an estimated $7.4 billion of revenue at existing income levels, the net cost after allowing for the revenues generated by the expansion in income and profits induced by the tax program, would be limited to approximately $3.5 billion. The expansionary effect of the tax reductions on future years' revenues can be expected to be considerably larger than for the first 2 years. The order of magnitude was indicated in the discussion in part II.

Table 3 shows by adjusted gross income class the distribution of changes in estimated tax liabilities for individuals when your committee's bill is fully effective. This table shows this distribution for each of the major rate and structural changes. These data are shown both in terms of amount of tax liability involved and the percentage change each of these is of present tax liability. It indicates that the rate changes alone would decrease tax liability by 20 percent while the structural changes would increase tax liability by 1.2 percent, resulting in the net reduction of 18.8 percent.

In table 3 the impact of the capital gains provisions is excluded because of the difficulty of showing these changes by adjusted gross income classes. Therefore, table 4 shows the revenue effect of each of the capital gain and loss provisions and shows the distribution of this revenue between individuals and corporations. The table also shows the anticipated temporary pickup in revenues expected as the result of the induced sales of securities occurring because of the lower inclusion factor and capital gains alternative tax for assets already held over 2 years.

TABLE 3.—*Change in estimated tax liability resulting from rate and structural changes[1] provided for individuals by your committee's bill when fully effective*

[In millions of dollars]

Adjusted gross income class	Rate change	Structural changes: Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Total	Total
0 to $3,000	−400	[2]	5	10	[2]	[2]	[2]	[2]	[2]	[2]	----------	−170	−155	−555
$3,000 to $5,000	−1,020	[2]	20	50	5	[2]	10	[2]	−5	−15	----------	−100	−35	−1,055
$5,000 to $10,000	−3,905	[2]	55	220	25	[2]	30	[2]	[2]	−25	[2]	−50	+255	−3,650
$10,000 to $20,000	−2,285	[2]	25	130	15	[2]	50	[2]	[2]	−15	−10	----------	+195	−2,090
$20,000 to $50,000	−1,150	5	5	60	5	[2]	85	−5	[2]	−5	−20	----------	+130	−1,020
$50,000 and over	−710	10	[2]	50	[2]	15	125	−5	[2]	[2]	−10	----------	+185	−525
Total	−9,470	15	110	520	50	15	300	−10	−5	−60	−40	−320	+575	−8,895
	Change as a percent of present tax													
0 to $3,000	−27.6	[2]	0.3	0.7	[2]	[2]	[2]	[2]	[2]	[2]	----------	−11.7	−10.7	−38.3
$3,000 to $5,000	−25.3	[2]	.5	1.2	0.1	[2]	0.2	[2]	−0.1	−0.4	----------	−2.5	−.9	−26.2
$5,000 to $10,000	−21.3	[2]	.3	1.2	.1	[2]	.2	[2]	[2]	−.1	[2]	−.3	+1.4	−19.9
$10,000 to $20,000	−18.0	[2]	.2	1.0	.1	[2]	.4	[2]	[2]	−.1	−0.1	----------	+1.5	−16.4
$20,000 to $50,000	−17.0	0.1	.1	.9	.1	[2]	1.3	−0.1	[2]	−.1	−.3	----------	+1.9	−15.1
$50,000 and over	−17.0	.2	[2]	1.2	[2]	0.4	3.0	−.1	[2]	[2]	−.2	----------	+4.4	−12.6
Total	−20.0	[2]	.2	1.1	.1	[2]	.6	[2]	[2]	−.1	−.1	−.7	+1.2	−18.8

[1] Excluding capital gains.

[2] Less than $2.5 million or 0.05 percent.

TABLE 4.—*Revision in taxation of capital gains and losses when all provisions of your committee's bill are fully effective (1965)*

[In millions of dollars]

	Individual	Corporate	Total
Direct effects:			
1. Reduced inclusion percentage	−230		−230
2. Unlimited loss carryforward	−30		−30
3. Sale or exchange of real estate		+15	+15
4. Sales of residences by taxpayers aged 65 or over	−10		−10
5. Treatment of iron ore royalties		−5	−5
Total direct effects	−270	+10	−260
Induced effects:			
1(*a*) Reduced inclusion percentage—induced unlocking	+450		+450
1(*b*) Deferral effect on gains between 6 months and 2 years	−10		−10
Total induced effects	+440		+440
Total effects	+170	+10	+180

IV. GENERAL EXPLANATION

A. RATE CHANGES

1. *Individual income tax rates (sec. 111 of the bill and sec. 1 of the code)*

The most important change made by this bill is the individual income tax rate reduction. The bill provides an individual income tax reduction of $9.47 billion spread over the 2 calendar years, 1964 and 1965. Over this 2-year period, the present rates, which range from 20 percent on the first $2,000 or $4,000 (the former for single persons and the latter for married couples) and 91 percent on incomes over $200,000 or $400,000 are reduced to a range of from 14 percent on the first $500 or $1,000 to 70 percent on incomes over $100,000 or $200,000. This represents an average rate reduction of 20 percent. Approximately two-thirds of this reduction is made effective in 1964 and the remaining one-third in 1965.

Table 5 shows the individual income tax rates under present law and under your committee's bill, both for 1964 and for subsequent years. A separate table with rates, as nearly as possible halfway between those applicable for single persons and for married couples, is provided for heads of households. The withholding tax rate of 18 percent under present law is reduced to 15 percent for the calendar year 1964 and to 14 percent for 1965 and subsequent years. Wage bracket withholding tables provided by the bill reflect similar reductions in withholding tax rates. The 14 (or 15) percent withholding tax rate is designed to withhold the appropriate amount of tax at an income level of $2,000 for a single person, or $4,000 in the case of a married couple using the standard deduction.

TABLE 5.—*Individual income tax rates under present law and schedules provided by committee's bill for 1964 and 1965*

Taxable income brackets (in thousands of dollars)		Present rates	Rates provided under committee bill—	
Single person	Married (joint)		1964 [1]	1965
		Percent	*Percent*	*Percent*
0 to 0.5	0 to 1	20	16.0	14
0.5 to 1	1 to 2	20	16.5	15
1 to 1.5	2 to 3	20	17.5	16
1.5 to 2	3 to 4	20	18.0	17
2 to 4	4 to 8	22	20.0	19
4 to 6	8 to 12	26	23.5	22
6 to 8	12 to 16	30	27.0	25
8 to 10	16 to 20	34	30.5	28
10 to 12	20 to 24	38	34.0	32
12 to 14	24 to 28	43	37.5	36
14 to 16	28 to 32	47	41.0	39
16 to 18	32 to 36	50	44.5	42
18 to 20	36 to 40	53	47.5	45
20 to 22	40 to 44	56	50.5	48
22 to 26	44 to 52	59	53.5	50
26 to 32	52 to 64	62	56.0	53
32 to 38	64 to 76	65	58.5	55
38 to 44	76 to 88	69	61.0	58
44 to 50	88 to 100	72	63.5	60
50 to 60	100 to 120	75	66.0	62
60 to 70	120 to 140	78	68.5	64
70 to 80	140 to 160	81	71.0	66
80 to 90	160 to 180	84	73.5	68
90 to 100	180 to 200	87	75.0	69
100 to 150	200 to 300	89	76.5	70
150 to 200	300 to 400	90	76.5	70
200 and over	400 and over	91	77.0	70

[1] Provides ⅔ of tax cut in 1964.

The rate brackets provided by your committee's bill differ from those under present law in that what is now the first bracket is divided into four brackets:

Single persons	*Married couples*
$0 to $500	$0 to $1,000
$500 to $1,000	$1,000 to $2,000
$1,000 to $1,500	$2,000 to $3,000
$1,500 to $2,000	$3,000 to $4,000

Splitting this first bracket into four brackets has several advantages. First, it makes it possible to have a lower starting rate than would otherwise be possible, given the same revenue loss. Only splitting this first bracket into four parts makes it possible to provide a 30-percent tax reduction for those with the lowest taxable income, who need the tax cut the most. Second, it makes it possible to provide some progression in the portion of the rate structure where none has been provided before. The significance of this is that over half of the taxpayers presently are subject only to the first bracket rate. As among taxpayers in this major group, the present rate structure provides no differentiation in applicable tax rates.

Table 6 shows the percentage of tax rate reduction provided in each rate bracket for 1965 and subsequent years. This table indicates that the new 14-percent rate represents a 30-percent reduction; the 15-percent rate, a 25-percent cut; and the 16-percent rate, a 20-percent cut. The average reduction in these first four brackets is 22.5 percent. Above this level the percentage reductions, up to a taxable income level of about $50,000 for single persons or $100,000 for married couples, is as nearly a uniform 15-percent rate reduction as practicable for a smooth progression. Above this $50,000 or $100,000 taxable income level, the rate reductions again gradually increase until the top rate is reached at $200,000 or $400,000 where a 23-percent rate reduction is provided. This rate schedule, therefore, provides a minimum reduction of approximately 15 percent for all tax brackets. In addition, it provides extra reductions in the very lowest tax brackets where the impact of the present taxes is the most heavy. It also provides larger reductions in the very highest bracket where it is quite clear the present rates are too steeply graduated. These rates, which were developed during World War II to assure equality of sacrifice, are no longer appropriate under today's conditions.

TABLE 6.—*Individual income tax rate schedules*

SCHEDULES UNDER PRESENT LAW AND UNDER COMMITTEE BILL FOR 1965

Taxable income bracket (thousands of dollars)		Present law rate	Committee bill		
Single person	Married (joint)		Rate for 1965 and subsequent years	Percentage reduction from present law rates	
		Percent	*Percent*	*Percent*	
0 to 0.5	0 to 1	20	14	30	
0.5 to 1	1 to 2	20	15	25	22.5
1 to 1.5	2 to 3	20	16	20	
1.5 to 2	3 to 4	20	17	15	
2 to 4	4 to 8	22	19	14	
4 to 6	8 to 12	26	22	15	
6 to 8	12 to 16	30	25	17	
8 to 10	16 to 20	34	28	18	
10 to 12	20 to 24	38	32	16	
12 to 14	24 to 28	43	36	16	
14 to 16	28 to 32	47	39	17	
16 to 18	32 to 36	50	42	16	
18 to 20	36 to 40	53	45	15	
20 to 22	40 to 44	56	48	14	
22 to 26	44 to 52	59	50	15	
26 to 32	52 to 64	62	53	15	
32 to 38	64 to 76	65	55	15	
38 to 44	76 to 88	69	58	16	
44 to 50	88 to 100	72	60	17	
50 to 60	100 to 120	75	62	17	
60 to 70	120 to 140	78	64	18	
70 to 80	140 to 160	81	66	19	
80 to 90	160 to 180	84	68	19	
90 to 100	180 to 200	87	69	21	
100 to 150	200 to 300	89	70	21	
150 to 200	300 to 400	90	70	22	
200 and over	400 and over	91	70	23	

The rate reductions found in table 6 reflect only the marginal rate reduction, or the rate reduction in each bracket. From the standpoint of the reduction in the total tax burden, however, it is important to realize that all taxpayers benefit from the rate reductions in all of the tax brackets below their top, or marginal, bracket. Thus, every taxpayer receives the benefit of the 30-percent reduction in the first bracket, either on his entire taxable income or on his first $500 or $1,000 of taxable income. Table 7 reflects this accumulative effect of the rate reduction provided by your committee's bill. This is accomplished by showing for the top of each rate bracket—both for married couples and for single persons—the total tax under present law and under your committee's bill for 1965, together with the decrease, in terms of dollars and also percentages, which this represents in present tax liability. This indicates that on an accumulative basis the large rate reduction in the bottom bracket has an important effect on income up to $8,000 for married couples (or $4,000 for single persons) and is of some significance for income levels up to about $40,000 for married couples (or $20,000 for single persons).

TABLE 7–A.—*Comparison of individual income tax liability under present law and under your committee's bill*

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Amount of taxable income	Tax		Decrease in tax in committee bill	
	Present law	Committee bill	Amount	Percent
$1,000	$200	$140	$60	30.0
$2,000	400	290	110	27.5
$3,000	600	450	150	25.0
$4,000	800	620	180	22.5
$8,000	1,680	1,380	300	17.9
$12,000	2,720	2,260	460	16.9
$16,000	3,920	3,260	660	16.8
$20,000	5,280	4,380	900	17.0
$24,000	6,800	5,660	1,140	16.8
$28,000	8,520	7,100	1,420	16.7
$32,000	10,400	8,660	1,740	16.7
$36,000	12,400	10,340	2,060	16.6
$40,000	14,520	12,140	2,380	16.4
$44,000	16,760	14,060	2,700	16.1
$52,000	21,480	18,060	3,420	15.9
$64,000	28,920	24,420	4,500	15.6
$76,000	36,720	31,020	5,700	15.5
$88,000	45,000	37,980	7,020	15.6
$100,000	53,640	45,180	8,460	15.8
$120,000	68,640	57,580	11,060	16.1
$140,000	84,240	70,380	13,860	16.5
$160,000	100,440	83,580	16,860	16.8
$180,000	117,240	97,180	20,060	17.1
$200,000	134,640	110,980	23,660	17.6
$300,000	223,640	180,980	42,660	19.1
$400,000	313,640	250,980	62,660	20.0

TABLE 7–B.—*Comparison of individual income tax liability under present law and under your committee's bill*

SINGLE PERSONS

Amount of taxable income	Tax		Decrease in tax in committee bill	
	Present law	Committee bill	Amount	Percent
$500	$100	$70	$30	30.0
$1,000	200	145	55	27.5
$1,500	300	225	75	25.0
$2,000	400	310	90	22.5
$4,000	840	690	150	17.9
$6,000	1,360	1,130	230	16.9
$8,000	1,960	1,630	330	16.8
$10,000	2,640	2,190	450	17.0
$12,000	3,400	2,830	570	16.8
$14,000	4,260	3,550	710	16.7
$16,000	5,200	4,330	870	16.7
$18,000	6,200	5,170	1,030	16.6
$20,000	7,260	6,070	1,190	16.4
$22,000	8,380	7,030	1,350	16.1
$26,000	10,740	9,030	1,710	15.9
$32,000	14,460	12,210	2,250	15.6
$38,000	18,360	15,510	2,850	15.5
$44,000	22,500	18,990	3,510	15.6
$50,000	26,820	22,590	4,230	15.8
$60,000	34,320	28,790	5,530	16.1
$70,000	42,120	35,190	6,930	16.5
$80,000	50,220	41,790	8,430	16.8
$90,000	58,620	48,590	10,030	17.1
$100,000	67,320	55,490	11,830	17.6
$150,000	111,820	90,490	21,330	19.1
$200,000	156,820	125,490	31,330	20.0

Table 8 shows the distribution by adjusted gross income classes (as distinguished from taxable income classes) of both the rate and structural changes provided by the bill when these changes are fully effective. This table also shows the number of taxable returns and tax liability under present law, together with the tax liability which will remain when the rate reductions and other changes provided by this bill are fully effective. The table further shows the percentage distribution of the rate, structural, and total changes made by this bill (expressed as a percentage of present tax liability by income class). This indicates that the rate changes on the average represent a 20-percent reduction. The percentage reductions vary within the various income classes from 17 percent for adjusted gross income above $20,000 up to 27.6 percent for incomes below $3,000. Taking the structural changes into account, the overall reduction averages 18.8 percent and varies from a reduction of 12.6 percent for incomes over $50,000 up to a reduction of 38.3 percent for those incomes of $3,000 or less.

TABLE 8.—*Distribution by adjusted gross income class of the full-year effect of all tax changes [1] made by your committee's bill which directly affect individuals*

Adjusted gross income class (thousands of dollars)	Number of taxable returns (millions)	Tax liability under present law	Effect of your committee's bill			Total tax under your committee's bill
			Rate change	Structural changes	Total	
		In millions of dollars				
0 to 3	9.7	1,450	−400	−155	−555	895
3 to 5	10.5	4,030	−1,020	−35	−1,055	2,975
5 to 10	22.9	18,300	−3,905	+255	−3,650	14,650
10 to 20	6.7	12,710	−2,285	+195	−2,090	10,620
20 to 50	1.0	6,760	−1,150	+130	−1,020	5,740
50 and over	.2	4,170	−710	+185	−525	3,645
Total	51.0	47,420	−9,470	+575	−8,895	38,525
		Percent of tax liability under present law				
0 to 3		100.0	−27.6	−10.7	−38.3	61.7
3 to 5		100.0	−25.3	−.9	−26.2	73.8
5 to 10		100.0	−21.3	+1.4	−19.9	80.1
10 to 20		100.0	−18.0	+1.5	−16.4	83.6
20 to 50		100.0	−17.0	+1.9	−15.1	84.9
50 and over		100.0	−17.0	+4.4	−12.6	87.4
Total		100.0	−20.0	+1.2	−18.8	81.2

[1] Excluding capital gains.

The tax rate reductions described above take effect as of January 1, 1964 and January 1, 1965. For taxpayers with fiscal years falling partially in either the calendar year 1963 or the calendar year 1964, the bill provides for the proration of the rates applicable in the 2 years involved, according to the number of days in the fiscal year in question which falls in each calendar year.

The tax rate changes provided for individuals by this bill are expected to decrease tax liabilities in the calendar year 1964 by $6.3 billion and in the calendar year 1965 by $9.5 billion. The latter reduction is cumulative and includes the reduction of $6.31 billion for the calendar year 1964.

2. Minimum standard deduction (sec. 112 of the bill and sec. 141 of the code)

(*a*) *Present law.*—Under present law, single taxpayers who take the standard deduction, if they have no dependents, become ~~taxable on~~ income above $667. This represents a standard deduction of 10 percent ($67) plus the personal exemption ($600). For a married couple filing a joint return under present law, income becomes taxable above $1,333. This represents a 10-percent standard deduction ($133) plus two $600 exemptions. Similarly, a married couple with one child becomes taxable on income above $2,000 (a standard deduction of $200 plus three $600 exemptions).

(*b*) *General reasons for proposal.*—In addition to the rate reductions described above, your committee concluded that it was desirable to remove from the tax rolls those persons with minimum incomes and also to provide those with incomes just slightly above these levels a somewhat larger tax reduction than is made available generally through the rate cuts.

The minimum standard reduction that your committee has adopted, and which is described below, removes 1.5 million taxpayers, with very low incomes, from the tax rolls entirely.

The tax relief provided under this provision is almost entirely concentrated in the adjusted gross income classes of $5,000 or less, with much of it concentrated in income levels below $3,000. The total revenue loss anticipated from the minimum standard deduction of $320 million, for example, is distributed as follows:

Adjusted gross income class (thousands of dollars)	Change in tax liability from minimum standard deduction (millions of dollars)	Percentage change in present tax liability
0 to 3	−170	−11.7
3 to 5	−100	−2.5
5 to 10	−50	−.3
10 and over	0	0
Total	−320	−.7

The minimum standard deduction relieves persons at or near the subsistence level of much or all of their tax liability. In this respect the provision is much more economical than a personal exemption increase. The minimum standard deduction in your committee's bill provides a floor of $300 above his exemption for a single person, a floor of $400 above exemptions for a married couple, and one of $600 above exemptions for a married couple with two children. Yet an increase in exemptions of only $100 would cost $2.6 billion, and one of $200 would cost $5 billion in lieu of the $320 million cost entailed in the minimum standard deduction.

(*c*) *General explanation of proposal.*—Your committee's bill provides that taxpayers who use the standard deduction may use either the regular 10-percent deduction or a minimum standard deduction, whichever is the larger. The minimum standard deduction in effect is $300 for the first exemption and $100 for each additional exemption. In the case of a married person filing a separate return, however, the

minimum standard deduction is $200 for the first exemption and $100 for each additional exemption.[1] As under present law, the standard deduction, whether a "10-percent" deduction or a "minimum" deduction, may not exceed $1,000 (or $500 in the case of a married person filing a separate return).

Under your committee's bill, a single person would be allowed a minimum standard deduction of $300 which, together with the personal exemption of $600, would mean that he would have no tax to pay until his income exceeded $900. Similarly, a married couple with no children would be allowed a minimum standard deduction of $400 ($300 for the first exemption, plus $100 for the second exemption). As a result, the married couple would pay tax on income only in excess of $1,600. A head of a household with one dependent also would be subject to tax only on income above $1,600, since the minimum standard deduction in this case also would be $300, plus $100 for the dependent. A married couple, both over age 65, would receive a minimum standard deduction of $600; i.e., $300 with respect to the first exemption, and $100 with respect to the three additional exemptions. This together with their four exemptions would mean they would pay no tax on the first $3,000 of income. This would also be true of blind persons with double exemptions.

The income levels under present law and under your committee's bill at, or below, which there would be no tax, are as follows:

Status of taxpayer	Present law with 10 percent standard deduction	Minimum standard deduction provided by bill
Single person	[1] $667	$900
Married couple, no dependents or head of household, 1 dependent	[1] 1,333	1,600
Married couple, 1 dependent or head of household, 2 dependents	[1] 2,000	2,300
Married couple, 2 dependents or head of household, 3 dependents	[1] 2,667	3,000
Married couple, 3 dependents or head of household, 4 dependents	[1] 3,333	3,700
Married couple, 4 dependents or head of household, 5 dependents	[1] 4,000	4,400
Married couple, 5 dependents or head of household, 6 dependents	[1] 4,667	5,100
Married couple, 6 dependents or head of household, 7 dependents	5,333	5,800

[1] The amounts shown above assume that the income level under existing law is reached at exactly the level which would apply if a uniform 10 percent standard deduction were used. However, under present law for taxpayers with income below $5,000, a tax table with brackets is substituted for the uniform 10 percent. This modifies slightly all of the figures noted above. The income levels in these cases according to the tax table are: $674, $1,324, $1,999, $2,674, $3,349, $3,999, and $4,649 respectively.

Under your committee's bill, taxpayers have the right to change their election with respect to the minimum standard deduction at any time within the period in which they can amend their tax return, that is, generally within the period ending 3 years after the due date filing for a given return.

(*c*)(*i*) *Effective date.*—Generally, the minimum standard deduction applies to taxable years ending after December 31, 1963. However, for taxpayers with fiscal years straddling this date, the bill provides for a portion of the benefits of the minimum standard deduction in the same way as rate reductions, in accordance with the number of days before and after December 31, 1963, in such years.

(*d*) *Revenue effect.*—The minimum standard deduction provided by this bill is expected to reduce revenues in a full year of operation by $320 million.

[1] In the case of married couples, where 1 takes the 10-percent standard deduction, rather than the minimum standard deduction, the other spouse must also take the 10-percent standard deduction. However, both may, if they so desire, elect to take the minimum standard deduction, which, as indicated above, is $200 for the 1st exemption and $100 for each additional exemption in the case of married persons filing separate returns.

3. Amendments related to individual income tax rate reductions (sec. 113 of the bill and secs. 37 and 871 of the code)

(*a*) *Retirement income credit.*—Present law provides a tax credit on retirement for passive investment or pension income received by persons generally over age 65. However, the income taken into account for this credit must be reduced for tax exempt social security, or railroad retirement income, and for those under age 72 for income derived from work above a specified income level. In computing the credit, present law provides that the income eligible for the credit is to be multiplied by the "rate provided in section 1 for the first $2,000 of taxable income." Under present law, this rate is 20 percent. Under your committee's bill, however, since this bracket has been split into four brackets, there are four rates ranging from 14 to 17 percent, applicable to different segments of this first $2,000 of taxable income.

Your committee's bill provides that the rate of tax to be used in computing this credit in the future is to be 15 percent. This is as near the middle of the four rates applicable to the first $2,000 of income as is possible, without the use of fractional rates.

(*b*) *Tax on nonresident aliens.*—Under present law, nonresident aliens receiving income from sources within the United States, such as interest, dividends, rents, salaries, wages, etc., are taxed on this income at a flat 30-percent rate (unless applicable tax treaties provide some other rates). However, present law also provides that if the nonresident alien receives more than $15,400 from the specified sources within the United States, then the regular individual income tax will apply with respect to the nonresident aliens' income from sources within the United States (if this results in a higher tax than the flat rate 30-percent tax).

The income level of $15,400 in present law is the point at which a 30-percent flat tax rate with one exemption would be likely to approximate the regular income tax rate with exemptions and with progressive rates. Because of the rate reductions provided by your committee's bill, this income level of proximate equality rises, and has been established in the bill at $21,200.

4. Corporate rate reductions (sec. 121 of the bill and sec. 11 of the code)

Under present law, the total, or combined, corporate income tax rate is 52 percent. It consists of a 30-percent normal tax rate, applying to all corporate income, and a 22-percent surtax rate applying to corporate income in excess of $25,000. Thus, corporations are taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on their taxable income above that level.

Your committee's bill makes two basic changes in the rate structure provided by present law. First, it lowers the overall rate from 52 to 50 percent for 1964, and to 48 percent for 1965 and subsequent years. Second, it "reverses" the normal and surtax rate in order to provide greater relief for small business. Thus, it provides that the normal tax rate is to be 22 percent instead of 30 percent for 1964 and subsequent years. The surtax rate then, for 1964, is to be 28 percent, and for 1965 and subsequent years, 26 percent. Thus, your committee's bill provides a tax rate of 22 percent (in place of 30 percent) on the first $25,000 of a corporation's taxable income for both 1964 and subsequent years and a tax rate of 50 percent in 1964 and 48 percent in

1965 and subsequent years for the portion of a corporation's income over $25,000 (in lieu of the present 52 percent rate).

This reduction in corporate rates is important because it reverses the trend toward higher and higher corporate rates and also because it again makes the government a "junior," rather than "senior," partner in any venture a corporation may undertake, insofar as the sharing of corporate income before tax is concerned. This tax rate reduction should be an important factor in improving the rate of profitability for corporations and, therefore, should provide an incentive for business investment and economic modernization and growth. It should also aid corporations in the export market in competing with corporations in other countries, where the corporate rates may not be as high as in the United States.

This tax cut for corporations, when fully effective, will amount to $2.2 billion a year. It should, of course, be viewed in connection with the reduction provided by Congress last year in the form of an investment credit and the reform provided last year in the depreciation guidelines. These taken, together, provide corporations with a tax reduction of approximately $4½ billion.

The "reversal" of the corporate rates should be a substantial benefit to small business. The substitution of a 22-percent rate for the 30-percent rate represents a rate reduction of nearly 27 percent on the first $25,000 of income, as contrasted to the rate reduction for above $25,000 of slightly less than 8 percent. Moreover, as indicated in table 6, the benefit of this rate reduction on the first $25,000 of income is appreciable for income levels up to $100,000.

TABLE 9.—*Revenue effect* [1]

Surtax net income class (dollars)	Number of taxable corporations	Computed tax liability, present rates [2] (million)	Normal tax to 22 percent and combined rate to 48 percent	
			Amount of reduction (million)	Percent reduction
$0 to $25,000	467,500	$874	$233	26.7
25,000 to 50,000	54,000	636	126	19.8
50,000 to 100,000	25,000	759	94	12.4
100,000 to 1,000,000	25,500	3,427	299	8.7
1,000,000 and over	4,000	18,664	1,438	7.7
Total	576,000	24,360	2,190	9.0

[1] At 1963 levels of income.
[2] Excluding capital gains presently taxed at the alternative rate.

Your committee believes that it is important to provide a greater rate reduction for small businesses because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion. As a result, they have traditionally found it necessary to expand largely out of income remaining after tax.

The rate reductions provided by your committee's bill for corporations apply to taxable years beginning after December 31, 1963, in the case of the reversal of the normal and surtax rates and also in the case of the reduction of the general rate to 50 percent. The reduction in the corporate rate from 50 to 48 percent applies to taxable years

beginning after December 31, 1964. For fiscal year taxpayers, with years straddling either of these two dates, the bill provides that the reductions are to be prorated in accordance with the portion of the corporate year occurring after December 31, 1963 or after December 31, 1964.

The decrease of corporate rate from 52 to 50 percent in the calendar year 1964, and the reversal of the normal and surtax rates, is expected to decrease corporate tax liabilities for that year by $1.3 billion. The reduction in corporate tax liabilities for the calendar year 1965 and subsequent years (when the corporate rate will be further reduced to 48 percent) is expected to amount to $2.2 billion. This estimate is cumulative and includes the $1.3 billion loss referred to with respect to 1964 corporate tax liabilities.

5. *Current tax payments by corporations (sec. 122 of the bill and secs. 6074 and 6154 of the code)*

(*a*) *Present law.*—Under present law a calendar year corporation is required to pay 25 percent of its estimated tax in excess of $100,000 in the third quarter of the year in which the tax liability actually arises, or on September 15. Another one-fourth of this estimated tax is paid in the fourth quarter of the year of liability, or on December 15. The remainder of the tax is paid in two equal installments in the following year, the first installment being due at the same time as the tax return for that year, or on March 15, and the second and final installment being due on June 15. Comparable dates are provided for fiscal year corporations.

This system of paying two quarterly installments with respect to tax liability in excess of $100,000 in the same year in which the liability arises, was initially provided at the time of the adoption of the Internal Revenue Code of 1954. Before that time Congress had, in 1950, provided, in the case of calendar year corporations, that the tax was to be paid in two installments of 50 percent each on March 15 at the time for filing the return and on the following June 15, both of these payment dates being in the year immediately following the year in which the tax liability arose. (Comparable dates were provided for fiscal year corporations.) Prior to 1950, corporate taxes were payable in four installments of 25 percent each, the first two for calendar year corporations being on the dates specified above, and the last two on the following September 15 and December 15—both dates being in the year following the year in which the tax liabiliy arose.

(*b*) *General reasons for provisions.*—As indicated above, corporations presently are only on a partial pay-as-you-go basis. Individuals, on the other hand, either through withholding or through declarations, are on a full pay-as-you-go basis. Your committee's bill, with respect to tax liability in excess of $100,000, places corporations on essentially the same pay-as-you-go basis as is already true in the case of individuals. This is to be accomplished gradually over a 7-year period. With the corporate rate reduction also provided by this bill, spreading the acceleration in corporate payments over this 7-year period can be accomplished without raising any corporation's income tax payment above its tax for 1963 (assuming the same income level throughout).

At the present time, the larger corporations appear to have sufficient funds to meet their investment requirements. In fact, many of the larger corporations customarily fund their tax liabilities by investing currently in Treasury tax notes or other types of short-term debt.

Moreover, the cash and other liquid assets of corporations in 1962 amounted to $68.5 billion, or some five times the aggregate tax liability of these corporations. In any event, since in each year the acceleration in payments is offset or more than offset by the tax reduction, the speedup of corporate payments will not decrease internal funds available at the corporate level for investment. At the same time, the reduction in the rate of corporate tax will increase the profitability of investments, thus encouraging further expansion.

Since the acceleration of the corporate payments has no effect if tax liabilities are $100,000 or less, the smaller corporations which, in many cases, may have a shortage of internal funds available for investment, will not be affected by this provision. Such corporations will have additional funds available for investment through the general 4 percentage point corporate rate cut, and more especially through the 8 percentage point reduction in the tax applying to the first $25,000 of income.

(*c*) *General explanation of provision.*—Over the 7-year period, 1964 through 1970, your committee's bill, in effect, provides, in the case of calendar year corporations, that the two installment payments due on March 15 and June 15 of the year following the year of liability are to be advanced to April 15 and June 15 of the year of liability, leaving the September 15 and December 15 installment payments of 25 percent still due at the same time as under present law. (A comparable advance is made for fiscal year corporations.) Any liability, to the extent that it is not paid by estimated tax payments (for example, does not exceed $100,000), will still be payable in two installments after the close of the year of liability, on March 15 and June 15, in the same manner as under present law. The following tabulation shows the change in the percentage payment dates from present law to the system set forth in your committee's bill when it is fully effective in 1970 and subsequent years:

	Percentage payments	
	Present law	Under bill when fully effective in 1970
Payments in year of liability:		
Apr. 15	0	25
June 15	0	25
Sept. 15	25	25
Dec. 15	25	25
Payments in year following year of liability:		
Mar. 15	25	(1)
June 15	25	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The advance in corporate payments described above is achieved under your committee's bill over a 7-year period, commencing in 1964, with respect to tax liabilities arising in that year. For corporations with tax liabilities in excess of $100,000, the bill requires that they make first and second quarterly current payments of 1964 tax in excess of $100,000 of 1 percent in April and June of 1964 (assuming they are calendar year corporations), with these quarterly percentages

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increasing to 4 percent in 1965, 9 percent in 1966, 14 percent in 1967, 19 percent in 1968, 22 percent in 1969, and then 25 percent in 1970 and subsequent years. These percentages apply only with respect to the portion of the corporations' tax liabilities which exceed $100,000. This gradual shift of the corporate tax payments, with respect to tax liability above $100,000, can perhaps best be seen by the following tabulation.

	Percent of estimated tax to be paid on the 15th day of the—				Percent of tax to be paid on the 15th day of—	
	4th month	6th month	9th month	12th month	3d month	6th month
	of the year of liability				of the year following the year of liability	
1964	1	1	25	25	24	24
1965	4	4	25	25	21	21
1966	9	9	25	25	16	16
1967	14	14	25	25	11	11
1968	19	19	25	25	6	6
1969	22	22	25	25	3	3
1970 and any subsequent year	25	25	25	25	(1)	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The percentages of the tax liabilities to be accelerated for each of the years, 1964 through 1970, were selected so that the speedup in corporate payments would not exceed the reduction in tax liabilities provided by the bill. The effect of the speedup on corporate tax liabilities for a calendar year corporation having a $10 million tax liability is shown in table 10. As indicated by this table, the combined effect of the rate reduction with the acceleration of corporate payments in all years results in a net reduction in tax payments, even for a corporation with a taxable income of $10 million. Corporations with smaller incomes would fare still more favorably in this respect.

The present provisions exempting corporations from any additional charges for failure to comply with the provisions of the declarations of estimated tax are continued as under present law. Present law provides an additional charge equal to 6 percent per annum for underpayments only if the estimated tax payments fail to come under one of the following four categories:

(1) they amount to 70 percent of the tax shown on the final return after subtracting $100,000 and allowing credits;

(2) they amount to as much as the previous year's tax reduced by $100,000;

(3) they are equal to what last year's tax (less $100,000 and allowable credits) would have been had current rates been applicable to that year's income; or

(4) the installment with respect to the declaration for any quarter is equal to 70 percent of the tax (less $100,000 and allowable credits) due on the basis of the income received to date, placed on an annual basis.

TABLE 10.—*Example of the combined effect on a calendar year corporation of current tax payments and the tax rate reductions provided by your committee's bill (corporation assumed to have $10 million of taxable income and to base its estimates on 75 percent of this income* [1]*)*

Calendar year	Corporation payments		Calendar year	Corporation payments	
	Dollars	Percent of 1963		Dollars	Percent of 1963
1963	5,194,500	100.0	1968	5,145,513	99.1
1964	5,192,332	99.9	1969	5,004,707	96.3
1965	5,126,402	98.7	1970	5,004,707	96.3
1966	5,145,512	99.1	1971	4,793,500	92.3
1967	5,145,513	99.1			

[1] Your committee's bill provides for (1) a reduction of the normal tax rate to 22 percent in 1964; of surtax rate of 28 percent in 1964 and 26 percent in 1965; and (2) 1st and 2d quarter current payments in 1964 and 6 succeeding years of 1, 4, 9, 14, 19, 22, and 25 percent.

(*c*)(*i*) *Effective date.*—The changes described above with respect to the acceleration of corporate tax payments start in taxable years beginning after December 31, 1963, and will become fully effective for taxable years beginning after December 31, 1969.

(*d*) *Revenue effects.*—It has been estimated that this proposal will increase revenues in the fiscal year 1964 by $260 million and in the fiscal year 1965 by $900 million.

IV. GENERAL EXPLANATION

B. STRUCTURAL CHANGES

1. Dividend credit and exclusion (sec. 201 of the bill and secs. 34 and 116 of the code)

(*a*) *Present law.*—Under present law, individuals are allowed to exclude from their tax base the first $50 of dividend income. If a husband and wife each have dividend income (or if they have such income jointly), the exclusion claimed on a joint return may amount to as much as $100 of dividend income. In addition, under present law, a credit of 4 percent is allowed against tax for any dividends remaining after the $50 or $100 exclusion. This credit may not, however, exceed 4 percent of taxable income.[1]

(*b*) *General reasons for proposal.*—In 1954 when the present dividend credit and exclusions were adopted, the committee report indicated that these relief measures were provided because the earnings of a corporation are taxed twice, once as corporate income and again as dividend income when paid out to the shareholders. It was stated that in addition to this being a double tax on this type of income, it also was a deterrent to investment in corporations. The report in 1954 particularly stressed the effect of the penalty of double taxation in channeling investments in the form of indebtedness rather than equity capital or stock.

In fact, the reduction in the corporate rate by 4 percentage points provided by this bill probably does as much to remove any double taxation involved with respect to corporate distributions as would the continuance of the present 4 percent dividend credit. Moreover, from the standpoint of making funds available for investment in corporate enterprises, this reduction in tax with respect to retained earnings can be expected to have a more important impact on corporate investment than any reduction directed solely toward corporate income which is distributed. This greater encouragement for corporate investment has been provided not only by the corporate rate cut in this bill, but also by the investment credit allowed with respect to business investment in the Revenue Act of 1962. Your committee's action in this bill, in making this investment credit available without reduction in the depreciation base, provides still further inducements for business investment.

In addition, the notion that the dividend credit would encourage equity financing does not seem to be borne out by the events which have occurred since 1954. As pointed out to your committee by the Secretary of the Treasury in the hearings before your committee on this bill, the ratio of equity to debt financing by corporations has not increased despite the presence of the 4-percent credit.

[1] The dividend exclusion and credit are not allowed for dividends received from foreign corporations, China Trade Act corporations, exempt corporations, corporations deriving most of their income from U.S. possessions, real estate investment trusts, life insurance dividends, dividends from mutual savings banks, domestic building and loan associations, etc., and capital gains dividends from regulated investment companies.

The form of the present dividend credit, in any event, is undesirable since it reduces any double taxation by a much larger percentage for the higher income bracket stockholders than it does for those in the lower bracket. Information presented by the Secretary of the Treasury to your committee indicated that the dividend credit, even combined with the present exclusion, reduces the extra burden of double taxation by 10.4 percent in the highest income bracket, while reducing it by only 4.3 percent for those subject to the first bracket rate.

In view of these considerations, your committee concluded that it would be better to concentrate relief from any double taxation which it is possible to provide in a dividend exclusion rather than in a dividend credit. The dividend exclusion, in the area operative, completely removes any double taxation. Moreover, increasing the exclusion, as your committee's bill provides, will tend to encourage a broader stock ownership among those with relatively low income. At the same time, the repeal of the credit removes the discrimination in present law in favor of high bracket shareholders. Furthermore, removing the credit even though doubling the exemption available has the effect of raising $300 million of revenue in the calendar year 1965 and subsequent years, which your committee has devoted to further individual income tax rate reductions than would otherwise be possible.

(*c*) *General explanation of provision.*—In view of the consideration referred to above, your committee's bill decreases from 4 to 2 percent the credit against tax allowed for dividends received during the calendar year 1964. With respect to dividends received in 1965 and subsequent years, the credit is repealed altogether. Consistent with the treatment provided when the tax credit was 4 percent of the dividend income, the dividend credit allowable during the calendar year 1964 is to be limited to 2 percent of taxable income received by an individual during that year.

Your committee's bill provides that with respect to dividends received in the calendar year 1964 and subsequent years the maximum exclusion per individual with respect to dividends received from a domestic corporation is to be $100, in lieu of the $50 available at the present time. In the case of married couples, where each owns stock separately or where stock is owned jointly and joint returns are filed, the maximum exclusion will be $200 in place of the $100 applicable under present law.

(*c*)(*i*) *Effective date.*—As indicated above, the dividend credit is reduced from 4 percent to 2 percent with respect to dividends received in the calendar year 1964 and is repealed with respect to dividends received in 1965 and subsequent years. The dividend exclusion is doubled with respect to amounts received in the calendar year 1964 and subsequent years.

(*d*) *Revenue effect.*—The combined effect of the reduction and then repeal of the credit and the increase of the exclusion is expected to increase tax liabilities by about $120 million for the calendar year 1964 and by $300 million in the calendar year 1965 and subsequent years when the repeal of the credit becomes fully effective.

2. Investment credit: Repeal of provision reducing basis of property by 7 percent and other amendments (sec. 202 of the bill and secs. 48 and 1245 of the code)

(*a*) *Present law.*—Last year in enacting an investment credit, Congress in general allowed a credit equal to 7 percent of certain types of investment (3 percent in effect in the case of most public utilities). This amount may be offset in full against tax liability up to $25,000 and against one-quarter of the tax liability above this level. Property with an estimated useful life of 8 years or more is fully taken into account in computing this credit, property with an estimated life from 6 to 8 years is taken into account at two-thirds of its cost, while property with an estimated life from 4 years up to 6 years is taken into account at one-third of its cost. The credit for the most part is limited to purchases of tangible personal property. As a result machinery and equipment are the principal types of investment eligible for the credit.

As finally enacted in the Revenue Act of 1962, it was further provided that the base on which depreciation may be taken in the case of assets eligible for the investment credit was to be reduced by the amount of the credit. Thus, for example, where a taxpayer purchased a $100 asset and $7 of this purchase price was allowed as an investment credit, the basis on which depreciation could be computed with respect to the asset was decreased from $100 to $93.

(*b*) *General reasons for provisions.*—Although the investment credit enacted last year appears to have been successful in stimulating investment, several problems have arisen with respect to this credit which are dealt with in this bill.

First and most important of the changes made is the repeal of the requirement that the basis of property eligible for the investment credit be reduced by 7 percent of the qualified investment. This provision requires that if property costing $100 and eligible for an investment credit of $7 was acquired, the basis of this property for purposes of depreciation (or gain or loss on sale) was to be reduced from $100 to $93.

This provision has proved troublesome to taxpayers since it requires a downward basis adjustment with respect to eligible property, whether or not an investment credit is claimed for the property. Moreover, making this adjustment has presented recordkeeping problems for taxpayers, and also severely complicated the statutory language of the investment credit provision.

In addition, this basis adjustment for property severely restricted the incentive effect of the investment credit. In effect, this amendment converted the 7-percent credit into a 3½-percent credit for corporations, plus a 7-percent initial depreciation allowance. This result occurs because the decrease in basis of the asset which may be written off means that the equivalent of approximately one-half of the investment credit is recouped over the life of the asset in substantially the same manner as an initial depreciation allowance. This effect substantially reduces the incentive effect of the credit, since it means that approximately half of the benefits must be restored over the useful life of the asset. In effect, this transforms one-half of the credit into an interest-free loan.

To remove the recordkeeping and accounting problems which have arisen in connection with the basis adjustment provision and also to

provide a greater stimulus with respect to the investment credit, your committee's bill repeals this basis adjustment provision with respect to property placed in service after June 30, 1963. It also provides a means whereby over a period of time taxpayers may recoup their basis adjustments already made. The repeal of this provision restores the investment credit to the position taken by the House in 1962 with respect to this credit.

A second problem presented with respect to the investment credit arises in determining the amount of the credit in certain situations in the case of leased property. Under present law a lessor may pass on the benefits of any investment credit with respect to his purchases or other acquisitions to the lessee of the property. This was provided on the grounds that it was the lessee in such cases who was creating the additional market for investment. The existing provision in this respect provides that the amount of the investment credit, if the property is constructed by the lessor, is to be the appropriate percentage of the "fair market value" of the property. However, in all other cases involving leases the investment credit is to be the appropriate percentage of the basis of the property to the lessor. In practice, this has discriminated in favor of manufacturers of equipment relative to independent distributors. Thus, in the case of equipment leased by the manufacturer having a fair market value of $1,000 the investment credit passed through to the lessee in this case will be 7 percent of $1,000 or $70. However, if the same equipment is purchased from the manufacturer by an independent distributor at a dealer's discount of perhaps 25 percent, the basis of the property to the dealer would be $750. Thus, he could pass on an investment credit of only $52.50 instead of the $70. As a result, it is more advantageous for customers to lease the property directly from manufacturers, rather than from independent distributors. Your committee's bill removes this discrimination by basing the credit in both cases upon the fair market value of the property.

A third problem arises with respect to the treatment of escalators and elevators in the case of the investment credit. Among the categories of property not eligible for the investment credit are buildings and their structural components. The House committee report indicated that the term "structural components" of a building included such parts of a building as central air conditioning and heating systems, plumbing, and electrical wiring and lighting fixtures relating to the operation and maintenance of the building. The proposed regulations issued by the Treasury Department with respect to the term "structural components" provide an extensive list of the type of items considered to be structural components and therefore not eligible for the investment credit. Among these items are escalators and elevators. While these regulations are an accurate interpretation of the intention of Congress last year in this respect, nevertheless your committee believes that it is appropriate to reconsider the treatment of escalators and elevators for purposes of the investment credit. Escalators and elevators are closely akin to assets "accessory to the operation" of a business which presently are eligible for the investment credit. These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. Your committee further believes that new elevator

and escalator equipment represents an important aspect of modernization of plant and facilities.

For the reasons cited above, your committee has concluded that new elevators and escalators installed after June 30, 1963, and modernization of existing elevators after that date should be eligible for the investment credit. This, of course, also means that elevators and escalators will be treated as coming under the recapture provision enacted last year. This in general provides that depreciation deductions taken with respect to such equipment in the future are to give rise to ordinary income to the extent of any gain recognized on the sale of such property.

A fourth modification in the investment credit relates to the treatment of the credit by regulatory bodies. Both the House and Senate committee reports on the investment credit, as well as the statement of the managers on the part of the House with respect to the conference (and the floor statement on the Senate with respect to the conference report) state that the purpose of the investment credit was to stimulate investment by reducing the net cost of acquiring depreciable assets. This is shown by the following quotations. First, in the report of your committee on that bill:

> The investment credit will stimulate investments because—as a direct offset against the tax otherwise payable—it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment as it increases the expected return from their use. The investment credit will also encourage investment because it increases the funds available for investment. * * *

In the report of the Finance Committee of the Senate it was stated:

> The investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. * * *
>
> The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment. It is your committee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy.

Again, in the statement of the managers on the part of the House with respect to the conference committee, it was stated:

> It is the understanding of the conferees on the part of both the House and Senate that the purpose of the credit for investment in certain depreciable property, in the case of both regulated and nonregulated industries, is to encourage modernization and expansion of the Nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of new facilities over their productive lives.

Despite the statements cited above, the Federal Communications Commission has indicated that it is its policy that any benefits from

the investment credit made available by the Revenue Act of 1962 should "flow through" immediately to the customers. In addition, the staff of the Federal Power Commission has recommended the same position. This is clearly contrary to the intent of Congress in enacting this provision and as a result your committee has added a provision to this bill reasserting its position that it was and is not its intention that the Federal regulatory agencies require the benefit of the investment credit to "flow through" in this manner.

(c) *General explanation of repeal of basis adjustment provision.*—In the case of property placed in service after June 30, 1963, your committee's bill repeals the provision in existing law requiring a downward adjustment in the basis of property by 7 percent of the qualified investment.

In addition, the bill provides that the basis of property eligible for the investment credit which was placed in service before July 1, 1963, is to be increased by 7 percent of the qualified investment for such property, as of the first day of the taxpayer's first taxable year beginning after June 30, 1963—January 1, 1964, with respect to a calendar-year taxpayer.[1]

Where the lessor passed the benefit of the investment credit on to the lessee, present law provides that the deductions allowed to the lessee for payments to the lessor under the lease contract are to be adjusted downward to reflect an amount similar to the amount of basis denied in the case of other than lease property. The bill provides that where this has occurred the Treasury is to provide for upward adjustment in the deductions allowed to the lessee for amounts paid to the lessor to similarly reflect the restoration of basis adjustments in these cases.

The effect of the provisions described above is to provide for no downward adjustment in basis with respect to property placed in service after June 30, 1963. With respect to property placed in service before that time but in 1962 or 1963 and still on hand at the beginning of the taxpayer's first year beginning after that time (January 1, 1964, in case of calendar-year taxpayers) the basis on which depreciation is taken (or gain or loss in the case of sale) for property which was eligible for the investment credit is to be increased by the same 7 percent by which the basis was reduced when the property was acquired. This addition to basis in the case of those computing depreciation on a straight-line basis will be recouped ratably by the taxpayer over the remaining life of the assets. In the case of double declining balance depreciation the recoupment will occur somewhat more rapidly. This method of handling the restoration of the basis in the case of previously acquired investment credit assets makes the taxpayer "whole" without the necessity of refunds.

(c) (i) *Credit for leased property to lessee.*—As indicated above, present law provides that when the investment credit is passed through from the lessor to the lessee the investment credit is to be based on the fair market value of the property if the property was constructed by the lessor, but otherwise is to be determined from the basis of the property to the lessor. Your committee's bill provides that the investment credit in these lease cases is to be based on the

[1] The restoration of basis referred to above is to be reduced with respect to any previous restoration which may have arisen because the property was no longer eligible for the investment credit or because of conversion of industrial property to public utility use, therefore no longer being eligible for the full investment credit.

fair market value of the property, whether or not the lessor created the property. An exception to this rule is provided, however, where the property is leased by a corporation which is a member of an affiliated group to another member of the same affiliated group. In this latter case, since there is no lease to an "outsider," the investment credit will still be determined on the basis of the cost of the property to the lessor. This amendment applies to property, the possession of which is transferred to a lessee on or after the date of enactment of this bill.

(*c*) (*ii*) *Treatment of elevators and escalators.*—Elevators and escalators have not, up to this time, been eligible for the 7 percent investment credit, since they have been classified as structural components of a building which specifically were not eligible for the investment credit. Your committee's bill, however, modifies this rule. It provides in the case of elevators and escalators that where their construction, reconstruction or erection is completed after June 30, 1963, or the elevator or escalator is new in the hands of the taxpayer and is acquired after that date, then the cost of the elevator or escalator (or a reconstruction) is to be eligible for the investment credit.

In view of the fact that the investment in elevators and escalators is to be eligible for the investment credit, they also are to be treated as subject to the recapture provision (sec. 1245) enacted by Congress last year. However, only depreciation deductions taken with respect to periods after June 30, 1963, are to be subject to this ordinary income recapture where the elevator or escalator subsequently is sold at a gain (and then only to the extent of this gain are these depreciation deductions to be treated as ordinary income). This provision applies only to elevators and escalators sold after December 31, 1963.

(*c*)(*iii*) *Treatment of investment credit by Federal regulatory agencies.*—Your committee has added a provision to the bill making it clear that it was the intent of Congress in providing an investment credit last year, and that it is the intent of Congress this year in repealing the reduction in basis required with respect to investment credit assets, to provide an incentive for the modernization and growth of private industry, including regulated industries.

As a result, the bill specifies in two paragraphs the intent of Congress as to the treatment of the investment credit by Federal regulatory agencies. It states in the case of public utility property that these regulatory agencies are not, without the taxpayer's consent, for the purpose of establishing the cost of service of the taxpayer, to treat more than a proportionate part of an investment credit (determined with reference to the useful life of the property) as reducing the taxpayer's Federal income tax liabilities. Nor are they to accomplish a similar result by any other method. Public utility property for this purpose includes property of electric, gas, water, telephone, and telegraph public utilities which under present law is eligible for what in effect amounts to a credit of 3 percent.

The bill also provides restrictions for Federal regulatory agencies in the case of other regulated companies—such as natural gas pipelines, railroads, airlines, truck and bus operators, and other types of public carriers—which receive an investment credit of 7 percent of the investment in qualified property. It provides that Federal regulatory agencies are not, without the taxpayer's consent, for purposes of establishing the cost of service of the taxpayer, to treat any invest-

ment credit allowed him as reducing his Federal income taxes. Nor are the agencies to accomplish a similar result by any other method.

As indicated above in the case of the public utility property Congress is merely directing the Federal regulatory agencies not to "flow" the benefits of the investment credit "through" to the customers over any period shorter than the useful lives of the property involved. In the case of the other property Congress is directing the Federal regulatory agencies not to "flow" this benefit "through" at any time. This difference in treatment is attributable to the fact that Congress provided what in effect is a 3-percent credit for the public utility property rather than 7-percent credit because last year it was recognized that in their case part of the benefit from the investment credit would be likely to be passed on eventually to the customers in lower rates.

(c)(*iv*) *Effective dates.*—As indicated previously, the repeal of the basis adjustment is to apply with respect to property placed in service after June 30, 1963. However, property placed in service before that time, with respect to which a basis adjustment has already been taken, if still in the hands of the taxpayer on the first day of his taxable year beginning after June 30, 1963, is to receive an upward adjustment in basis.

The amendment concerning the amount of the investment credit in the case of leased property is to apply with respect to property transferred to a lessee on or after the date of enactment of this bill. The amendment made with respect to escalators and elevators in the case of the investment credit applies to those acquired or constructed after June 30, 1963. The recapture rule with respect to these assets applies to dispositions of escalators or elevators after December 31, 1963.

(*d*) *Revenue effect.*—The repeal of the basis adjustment with respect to the investment credit is expected to reduce tax liabilities by $145 million in the calendar year 1964 and by $185 million in the calendar year 1965 with gradually greater reductions in successive years. Making elevators and escalators eligible for the investment credit is expected to result in an additional $10 million of loss in the calendar year 1964 and subsequent years.

3. Group term life insurance purchased for employees (sec. 203 of the bill and secs. 79 and 218 of the code)

(*a*) *Present law.*—Under present law, employees are required to include in their income the amount of premiums paid by their employers to provide them with individual life insurance or group permanent life insurance which carries a loan or surrender value. However, the regulations (1.61–2(d)(2)) have provided that the cost of group term life insurance purchased for employees is not includible in their income as compensation although the employer receives deductions for the amounts he pays to provide this protection.

(*b*) *General reasons for provisions.*—As indicated above, this tax-free status for employer-financed group term life insurance is inconsistent with the tax treatment of other types of life insurance protection furnished employees by their employers. While this complete exclusion might have been considered relatively insignificant when tax rates were low, the present relatively high rates as well as the growing volume of group term life insurance now provided makes

it particularly inequitable to continue this complete exclusion. The employee in such case receives a substantial economic benefit from this insurance protection whether or not the policy for a specific year leads to a payment to his beneficiary. The provision of this insurance by the employer relieves the employee of substantial costs of providing his own insurance protection for his family which he would otherwise have to provide out of tax-paid dollars.

Despite the fact that the entire cost of this insurance protection represents compensation to the employee, your committee has provided an exemption with respect to the premiums paid on the first $30,000 of such insurance because it believes, from the standpoint of the economy as a whole, that it is desirable to encourage employers to provide life insurance protection for their employees. Provision of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely.

(c) *General explanation of provisions.*—For the reasons given above, your committee's bill provides that the gross income of an employee for tax purposes is to include the cost of any group term life insurance provided him under a policy carried directly or indirectly by his employer to the extent that the insurance coverage provided is in excess of $30,000. However, the employee will not be charged with any portion of this insurance protection over $30,000 which he provides himself through his own contributions, since insurance protection provided in this manner is paid for out of tax-paid dollars. Moreover, all contributions made by the employee are applied against insurance protection above the $30,000 exclusion level.

The cost of protection above $30,000 is taxed to an employee if it is provided under a plan arranged for by the employer whether the protection the employee receives (over and above that provided by his own contributions) is provided directly by the employer, or indirectly by the employer's charging more than the cost of the insurance to other employees (such as those in younger age brackets) and less to those in the older age brackets, such as the specific employee in question.

(c)(i) *Exception for retired employees, etc.*—Your committee's bill provides an exception to the general rule described above where the individual's employment has been terminated and either he has reached the normal retirement age (under the practice followed by his employer) or he has become disabled. In both of these cases your committee concluded that it would be undesirable to tax the aged or disabled individual who is no longer working for group term life insurance protection provided to him by his former employer.

Two other exceptions are also provided where the insurance protection provided by the employer will not be treated as compensation to the employee, even though in excess of the $30,000 coverage exclusion. First, it will not be taxed to the employee where the employer directly or indirectly is the beneficiary of the policy since in such cases the employer is in reality providing for his own rather than his employee's interest.

Secondly, the costs of the insurance protection in excess of $30,000 will not be taxed to the employee where the beneficiary of the policy is a charitable organization (of the type described in sec. 170(c) of the code). An exception is provided for such cases because it is recognized that where an employer provides protection for all of his em-

ployees, a few of them may not have natural heirs and, therefore, if left to their own choice, might not purchase insurance protection. It was concluded that in such cases, it would be unfair to tax such employees on the cost of insurance protection provided by employers. For this reason, it was thought that where the employee demonstrated his own personal disinterest in the protection by naming a charity as the beneficiary, no portion of the cost of such protection should be considered as income to him. It is not intended, however, that he receive any deduction for a charitable contribution with respect to such assignment.

(c)(ii) *Determining the cost of the insurance.*—Your committee's bill provides that the cost of the insurance protection can be determined under either of two methods. It can be determined by using a uniform table or by using the actual cost of the policy. In either case, the cost of the insurance is averaged out on the basis of 5-year age brackets, in order to simplify computations which must be made by the employer in informing the employee as to the amount of taxable income.

Where cost is determined on the basis of the uniform table referred to above, it will be determined on the basis of a table published in the Treasury Regulations on this provision.

This table will reflect costs of such protection based upon insurance company experience and, of course, will be changed from time to time as mortality experience or other factors indicate that this is appropriate. Until provided otherwise by regulation, however, the cost per $1,000 of group term life insurance protection can be determined from table 11 below.

TABLE 11.—*Uniform 1-year term premiums for $1,000 of life insurance protection*

[Cost per $1,000 of protection]

Age:	
15 to 19	$1. 44
20 to 24	1. 73
25 to 29	2. 11
30 to 34	2. 72
35 to 39	3. 65
40 to 44	5. 10
45 to 49	7. 36
50 to 54	10. 87
55 to 59	16. 29
60 to 64 [1]	24. 67

[1] Those age 65 and over whose employment is not terminated will also have their insurance cost computed on the basis of the 60 to 64 age category.

The second method which an employer may use in computing the cost of his employee's protection for tax purposes is the actual cost of the policy to him and the employees. In this case also, the same 5-year age brackets as provided under the uniform premium table are to be used. However, in any case where the cost of the insurance protection is not computed on the basis of the individual ages of the employees or on the basis of the same age brackets as provided under the uniform premium table, this second method of determining the cost of insurance protection may not be used.

Your committee's bill provides that in the case of employees (not retired) who are over age 64, the cost of this protection is not to be increased in such cases but instead is to continue to be computed on the same basis as those in the age bracket 60 to 64.

(c)(iii) *Deduction for certain contributions.*—Your committee recognizes that under some group term insurance plans the younger em-

ployees under the plan in effect pay for insurance protection provided for those in higher age brackets. This usually occurs where a uniform rate of contribution is required of all employees regardless of age. Sometimes the cost of the protection for those who are relatively young may not equal the contribution made by the employee. Your committee believed that since the cost of group term insurance protection above the $30,000 level would be taxable to an employee if in excess of his contributions, it is only appropriate to provide deductions to him where he contributes more than the cost of the protection provided him.

As a result, your committee has provided a special deduction in computing taxable income for contributions by the employee toward the purchase of group term insurance protection above the $30,000 level. For this purpose his contributions toward the purchase of group term insurance below the $30,000 level are not taken into account, since such insurance protection is below the taxable level. Also not taken into account are premiums paid for any insurance, the cost of which would not be includible in the employee's gross income if it exceeded $30,000 and he made no contribution.

(*c*)(*iv*) *Example of method of computation.*—To illustrate the method of computing the taxable cost of group term insurance it is first assumed that the employee makes no contribution toward this protection himself, and then that he makes a contribution of $2 per $1,000 of coverage. The method of computing the inclusion in the employee's gross income is illustrated by an employee age 41 who is provided with $70,000 of group term life insurance protection.

Where employee makes no contribution

Portion of insurance coverage taken into account ($70,000−$30,000)	$40, 000. 00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5. 10
Amount to be included in income tax base by employee ($5.10×40)	204. 00

Where employee makes contribution

Portion of insurance coverage taken into account ($70,000−$30,000)	$40, 000. 00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5. 10
Total cost of insurance attributable to employee's contribution ($2.00×70)	140. 00
Cost of insurance protection above $30,000 exclusion ($5.10×40)	204. 00
Amount to be included in income tax base by employee ($204−$140)	64. 00

The special deduction given employees where they contribute more than the cost of their own insurance also can be illustrated if one change is made in the assumed facts presented: Assume that the contribution made by the 41-year-old individual is $6 per $1,000 of insurance coverage rather than $2.

Where employee makes excess contribution

Portion of insurance coverage taken into account ($70,000−$30,000)	$40, 000. 00
Cost of insurance protection per $1,000 for an individual age 41 assuming uniform premium table is used	5. 10
Contribution of employee per $1,000 of insurance	6. 00
Contribution of employee per $1,000 in excess of cost of insurance ($6−$5.10)	. 90
Deduction available to employee ($40×$0.90)	36. 00

(*c*)(*v*) *Withholding.*—Your committee's bill also amends the income tax withholding provision of present law to provide that the cost of group term life insurance, to the extent the cost of this insurance is taxable, is to be subject to regular income tax withholding. However, where an individual is employed by two or more persons, each employer is to compute the taxable amount subject to withholding on the assumption that he is the only employer. Thus, each employer will report for form W–2 purposes for the employee, only that portion of the insurance protection provided in excess of $30,000 coverage. This may, where there are two or more employers, understate the taxable amount for the employee but this cannot be avoided since one employer cannot be expected to have knowledge of the compensation received by an employee from another employer.

(*c*)(*vi*) *Effective date.*—The tax treatment provided with respect to group term insurance as described above is to apply with respect to such insurance protection provided after December 31, 1963. The withholding with respect to this insurance will apply to remuneration paid after December 31, 1963, in the form of group term insurance provided after that date.

(*d*) *Revenue effect.*—It has been estimated that the enactment of the group term life insurance provision described above will result in an increase of $5 million in revenues in a year when this provision is fully effective.

4. Reimbursement of medical expenses in excess of such expenses (sec. 204 of the bill and sec. 80 of the code)

(*a*) *Present law.*—Present law provides that gross income is not to include amounts received through accident or health insurance for medical expenses for personal injuries or sickness (sec. 104(a)(3) and 105(b) of the code).[1] At the same time medical expense deductions may be claimed (if they exceed the 3-percent floor) for accident or health insurance premium payments.

(*b*) *General reasons for provision.*—Cases have been called to the attention of your committee where individuals have been covered by more than one accident or health insurance program. This occurs on occasion when the individual himself carries more than one policy, and occurs in other cases when the individual may carry a policy and also his employer may provide the payment of medical care either through an insurance policy or through self insurance. In these cases, the employee may receive double payments with respect to the same expenses incurred with respect to a given injury or sickness. Where this occurs, the individual has, in fact, bettered his economic position and your committee sees no reason why this excess over the actual expenses incurred should not be treated as income received by the individual.

(*c*) *General explanation of provision.*—For the reasons given above, your committee's bill provides that amounts received through accident or health insurance for medical expenses (but not, for example, specific amounts with respect to the loss of a limb) are to be included in the gross income of the individual to the extent the total amount received with respect to any personal injury or sickness exceeds the total

[1] An exception to this rule provides that amounts received under accident or health insurance policies are to be included in gross income to the extent they represent medical expense deductions allowed in previous years.

medical expenses payable by the taxpayer with respect to this personal injury or sickness.

Under this provision, payments received by an individual with respect to an injury or sickness are viewed in aggregate as of the close of each taxable year and only when the total amount received exceeds the total amount of medical expenses incurred is any amount treated as income. Thus, for example, an individual might be paid under two different policies with respect to a given hospital bill for the same illness but if the individual also had a doctor's bill to pay with respect to the same illness upon which he was not reimbursed, then even though the insurance received for hospital expenses exceeded the amount of the hospital bill, to the extent this excess did not exceed the doctor's bill, no amount would be included in the individual's income.

(*c*)(*i*) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

5. Sick pay exclusion (sec. 205 of the bill and sec. 105(d) of the code)

(*a*) *Present law.*—Under the present law amounts paid to an employee by his employer to continue his wage payments when he is absent from work because he is sick or injured are excludable from the employee's gross income under certain conditions (although deductible by his employer). The exclusion in any case is available only up to $100 per week. In the case of absence from work due to personal injuries, this $100 is the only limitation at the present time. In the case of sickness, however, the exclusion is available only after the first 7 days of absence, unless the employee is hospitalized because of the sickness for at least 1 day during his absence.

(*b*) *General reasons for provision.*—Your committee does not believe that this sick pay exclusion in its present form is justified. The amounts received by the employee in this case are substitutes for regular wages or salaries which, had they been received as such, would be fully taxable. The wage substitutes in this case are wholly unrelated to the costs involved as a result of illness or injury. Amounts paid by the employer for the medical expense of the employee already are excludable by the employee under other provisions of law (sec. 105(b)) and amounts paid by the employee himself for medical expenses also are deductible elsewhere under present law (sec. 213 of the code) to the extent that they exceed what is considered to be the normal level of medical expenses.

The present exclusion also tends to encourage malingering because it treats the employee who stays at home better than another employee also is easily abused because an employee who stays home because of a minor injury or illness may obtain an exclusion substantially in excess of any additional expenses he may incur.

Your committee believes, however, that those who have become permanently disabled or who have had long, continuing illnesses or accidents should continue to receive the advantage of this provision. Such persons are likely to have their earnings substantially decreased, at the same time they also may be faced with large medical bills. Moreover, in such cases, the ordinary family financial requirements are likely to continue at their usual level, presenting larger problems for the individual as the period of absence from work becomes longer.

(*c*) *General explanation.*—For the reasons presented above, your committee has amended the sick pay exclusion of present law to provide that wage continuation payments are not to be excludable to the extent they are attributable to the first 30 days of absence because of personal injury or sickness. This means, of course, that this exclusion will be available after the first 30 days of injury or sickness for the long, continuing illness and also in the case of those receiving permanent disability pensions before the normal retirement age.

Under present law employers who make wage continuation payments which are not excludable from the employee's income (e.g., payments in excess of $100 a week or payments for the first 7 days in the case of sickness where there is no hospitalization) are required to include these amounts in income subject to withholding and reporting on form W–2. This practice will be continued under the revised provision with the withholding and reporting applying to a larger proportion of the wage continuation payments. Where these payments are made by someone other than the employer, such as an insurance company or a pension trust, the Treasury does not presently require withholding and it is your committee's intention that this practice be continued. However, these payments are (if made on behalf of the employer) to be included on the W–2 form prepared by the employer and shown on this form as wages or salary.

(*c*)(*i*) *Effective date.*—The amendment made by your committee under this provision will apply to wage payments attributable to periods of absence commencing after December 31, 1963.

(*d*) *Revenue effects.*—It is estimated that the provision described above, when fully effective, will result in an increase in revenues of $110 million a year.

6. Exclusion for gain on the sale of a residence by an individual age 65 or over (sec. 206 of the bill, sec. 121 of the code)

(*a*) *Present law.*—Under present law (sec. 1034) where an individual sells his old residence and, within a year of that sale, purchases a new residence (or within 18 months thereafter builds a new residence), the gain on the sale of the old residence is not recognized to the extent that it, plus the cost or other basis of the old residence, is invested in the new residence. This postponement of the taxation of the gain is available only where the new residence is purchased or built within the time specified.

(*b*) *General reasons for the provisions.*—While present law generally provides adequately for the younger individual who is for one reason or another changing residences, it does not do so for the elderly person whose family has grown and who no longer has need for the family homestead. Such an individual may desire to purchase a less expensive home or move to an apartment or to a rental property at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses. Nevertheless, under present law, such an individual must tie up all of his investment from the old residence in a new residence, if he is to avoid taxation on any of the gain which may be involved.

Your committee concluded that this is an undesirable burden on our elderly taxpayers.

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(c) *General explanation.*—For the reasons given above, your committee's bill provides an exclusion from gross income for a limited amount of gain received from the sale or exchange of a personal residence in the case of taxpayers who have reached age 65 before the sale or exchange occurs. To be eligible for this treatment, they must have owned and used the property involved as their principal residence for 5 out of the last 8 years before the sale or exchange.

(c)(i) *Limitations.*—In adding this provision, your committee was concerned primarily with the average and smaller homestead selling for $20,000 or less. For that reason, it limited the application of this section so that it provides a full exclusion only for the gain attributable to the first $20,000 of the sales price.[1] Where the sale price of the residence does not exceed $20,000, the entire gain is excluded from income for tax purposes. Where the sale price exceeds $20,000, a proportion of the gain is excluded. The proportion excluded is in the ratio of $20,000 to the actual sale price; for example, if a residence is sold for $60,000 and the gain is $10,000, then the portion of this $10,000 gain which will not be taxable is determined as follows:

Actual sale price	$60, 000
Ratio of $20,000 to sale price ($20,000/$60,000)	⅓
Proportion of $10,000 gain to be excluded from taxable income (⅓ of $10,000)	$3, 333. 33
Remaining gain subject to tax	$6, 666. 67

To prevent taxpayers over age 65 from reusing this section and obtaining numerous exclusions for gains on personal residences, your committee's bill provides that this exclusion is available to a taxpayer and his spouse only once in their lifetimes.

(c)(ii) *Other rules.*—Since a taxpayer and his spouse may claim the exemption under this provision only once in their lifetimes, the bill provides that the exclusion is elective and may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of tax, generally about 3 years after the year of the sale or exchange. It also was necessary to provide a number of other special rules for the application of this provision. These rules may be described briefly as follows:

1. Where property is held jointly by a husband and wife either as joint tenants, tenants by the entirety or as community property, if a joint return is filed by the husband and wife and one of them satisfies the age requirement of 65 and has held and used the property for the required 5 out of the last 8 years, then both the husband and wife are treated as meeting these requirements.

2. Where the spouse of an individual has died and that spouse held and used the property as a personal residence for 5 out of the last 8 years and had not previously claimed an exemption under this provision, then the individual who is still living will be treated as satisfying these holding and use requirements. (However, the surviving spouse must be age 65 for the exclusion to apply.)

3. The bill provides that for purposes of this provision tenant stockholders in a cooperative housing corporation who sell their right to occupy the house or apartment are to be treated in the same manner

[1] Actually the determination is made on the basis of adjusted sales price which as provided elsewhere in the code is the gross sales price less any so-called fix-up expenses incurred in selling the property. In this regard, see sec. 1034(b)(1).

for purposes of this provision as those who own their residence outright.

4. Any gain realized from the destruction, theft, seizure, requisition, or condemnation of a personal residence is to be eligible for this provision in the same manner as if the residence had been sold.

5. Where a part of a property is used as a personal residence and the remainder as a business or income producing property, the exclusion provided under this provision upon the sale of the property is to be available to the extent that the gain is attributable to the portion of the property owned and used by the taxpayer as his personal residence.

6. In applying this provision, an individual is to be considered as married or single according to his status on the date of the sale or exchange. An individual who is separated under a decree of divorce or separate maintenance on the date of the sale is not considered as married for purposes of this provision.

7. In the case of involuntary conversions and in the case of the sale or exchange of one personal residence for another, gain is not recognized under present law where the total amount realized from the conversion or sale is reinvested within a specified period of time. In addition, the basis of the new property so acquired in such cases remains the same (except for any additional investments over and above the sales price) as the property previously held. Where both the exclusion available for taxpayers over age 65 and either of these two provisions may be applied with respect to the same transaction. the bill provides that the exclusion for those over age 65 is to be applied first. Thus, in the case of the involuntary conversion or the sale of a personal residence and the purchase of another, by a taxpayer who is over age 65, any gain which might be realized upon the involuntary conversion or sale of the residence will be reduced by any exclusion available to the taxpayer under this section. In addition, the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision (and, of course, increased by any additional funds which he may have invested over and above the amount realized from the first residence).

8. In determining whether an individual has gross income of $600 or more (or $1,200 or more in the case of those over age 65) any exclusion provided under this provision will for that purpose alone be treated as gross income. This assures that the Government will receive proper reporting on amounts claimed as exclusions under this provision.

(*c*)(*iii*) *Effective date.*—This provision applies to sales, exchanges, and other dispositions after December 31, 1963.

(*d*) *Revenue effects.*—This provision is expected to result in an annual revenue loss of $10 million.

7. Denial of deduction for certain State, local, and foreign taxes (sec. 207 of the bill and secs. 164 and 275 of the code)

(*a*) *Present law.*—The general rule under present law is that taxes paid or accrued by a taxpayer are deductible for Federal income tax purposes. However, an exception to this rule provides that no deduction is to be allowed for certain specified taxes, principally Federal

taxes. The categories of taxes which may not be deducted under present law are:

1. Federal income taxes.
2. Federal war profits and excess profits taxes.
3. Federal import duties and Federal excise and stamp taxes (except that these taxes may be deductible as business expenses or taken into account as expenses incurred in the production of income).
4. Estate, inheritance, gift, and similar taxes.
5. Most local improvement taxes.
6. Foreign income and excess profits taxes and similar taxes imposed by U.S. possessions (if the taxpayer elects to take a foreign tax credit for these taxes in lieu of a deduction).

The practical effect of the above listing of taxes is to deny any deduction for Federal taxes paid by the taxpayer (except to the extent that taxes listed in category 3 above qualify as business expenses or expenses incurred in the production of income).

State and local taxes on the other hand generally are deductible, except death and gift taxes and most local improvement taxes. The most important State and local taxes, and the revenues derived from them by State and local governments in 1961, are as follows:

1. Real and personal property taxes, $18 billion.
2. Income taxes, $3.9 billion.
3. General sales and gross receipts taxes, $5.4 billion.

The three categories of taxes indicated above account for $7.5 billion of the total $10 billion of taxes taken as non-business deductions on taxable returns for Federal income tax purposes in 1960. The principal remaining State and local taxes, for which deductions may presently be taken, together with revenues derived from them by State and local governments in 1961, are as follows:

1. Gasoline taxes, $3.5 billion.
2. Alcoholic beverage taxes, $0.7 billion.
3. Tobacco taxes, $1.1 billion.
4. Auto and drivers' licenses, $1.8 billion.
5. Selective sales or excise taxes not included above (such as those on admissions, room occupancy, etc.), $1.8 billion.

(*b*) *General reasons for the provision.*—Your committee recognized that there were important reasons for continuing the deductibility of property taxes, income taxes, and general sales taxes. The burden of property taxes varies widely among individuals according to whether or not they are homeowners. Thus, any denial of deductions in such cases would result in an important shift in the distribution of Federal income taxes between homeowners and nonhomeowners.

In the case of State and local income taxes, continued deductibility represents an important means of accommodation where both the State and local governments on one hand and the Federal Government on the other hand tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case, could mean that the combined burden of the State, local, and Federal income taxes might be extremely heavy.

If property and income taxes are to be deductible in computing income subject to Federal income tax, it also becomes important to allow the deduction of general sales taxes as well. These are the three major sources of State and local government revenue, and were the

Federal Government to allow the deduction of some but not all of these taxes, it would be encouraging State and local governments to use one or more of the other types of taxes. Since your committee believes that it is important for the Federal Government to remain neutral as to the relative use made of these three forms of State or local revenue sources, it in this bill has continued a deduction of these three types of taxes.

The same reasoning does not, however, apply to other State or local taxes which presently are deductible. Moreover, the remaining State and local taxes, which are deductible, for the most part are troublesome for taxpayers to keep track of, and because of this difficulty it is believed that they frequently are unintentionally reported inaccurately. Deductions for property and income taxes can be relatively easily claimed, since the taxpayer in these cases usually can pick out one or two figures from his records for this purpose. In the case of general sales taxes, the Internal Revenue Service has prepared tables which make it possible for a taxpayer to pick from the table the deduction for general sales taxes which the Internal Revenue Service considers to be an appropriate estimate for an individual with a given income. As a result, this deduction also no longer represents a major problem of computation for taxpayers. In the case of the remaining excise taxes, however, consumer use varies so widely that it has been impossible for the Service to develop estimates which may appropriately be used by taxpayers in determining the size of these tax deductions. For this reason, the taxpayer who accurately determines his deductions for gasoline taxes, alcoholic beverage taxes, tobacco taxes, and other selective sales or excise taxes, must actually keep a record of taxes paid, purchase by purchase. Since this is virtually impossible for most taxpayers, deductions in these cases usually represent, at best, mere approximations. Many taxpayers who report their income carefully for tax purposes are not satisfied with this type of approximation, and, therefore, forgo the deduction of these taxes altogether.

Also, it should be noted that some of these taxes are deductible if paid in some States and not in others depending on the form of the State law. Sales taxes, to be deductible under Federal law, must be either imposed upon the purchaser, or else be separately stated. In the case of cigarette and tobacco taxes, 26 States levy taxes which comply with these rules and, therefore, are deductible. However, 21 States and the District of Columbia have laws which do not meet these conditions and thus in these States no deductions are available for these taxes.[1] There also is a wide variation among the States as to the deductibility of alcoholic beverage taxes. In six States, these taxes are imposed on the consumer and, therefore, are deductible. In addition, in 10 other States, where alcoholic beverages are sold through State liquor stores, the tax also generally is deductible. In all other States, however, the tax is not deductible.[2] This variation as to the Federal tax treatment of these various excise taxes is discriminatory as between taxpayers in different States. Moreover, it further complicates the already difficult problem of reporting deductible taxes in these cases.

[1] Three States, Colorado, North Carolina, and Oregon, do not levy cigarette taxes.
[2] Seven States do not levy taxes on liquor except beer and in some cases wine. The beer and wine taxes of these States are not deductible.

Your committee concluded from the above considerations that in the interest of tax equity and ease of compliance it would be appropriate in the case of these latter taxes to deny deductions for Federal income tax purposes, devoting any revenue gain derived from the denial of these deductions to further tax rate reductions. This denial of deduction was, therefore, taken into account by your committee in providing the large tax rate reductions established by this bill. When records of deductions are difficult or impossible to maintain, the committee thought that most taxpayers would be willing to forgo these deductions if the tax rates in the same bill are reduced so that in all cases lower tax payments result. Your committee would not have considered the denial of these deductions were it not possible to convert this amount into rate reductions.

(c) *General explanation of provision.*—For the reasons given above, your committee's bill provides as a general rule that only the following taxes may be taken as deductions:

1. State and local personal property taxes;
2. State and local, and foreign, real property taxes;
3. State and local, and foreign, income, war profits, and excess profits taxes; and
4. State and local general sales taxes.

The fact that only these taxes may be deducted as taxes does not mean that other State, local, and foreign taxes may not be deducted to the extent they represent trade or business expenses or expenses incurred in the production of income. A sentence added to the code on this point makes it clear that these other State, local, and foreign taxes may be deducted as taxes when they are of a business nature or for the production of income even though otherwise they might have to be capitalized.

(c)(i) *Taxes which in no event may be deducted.*—Under present law certain taxes, largely Federal taxes, may not be deducted in any case either as taxes or as business expenses or as expenses incurred in the production of income. To make clear the distinction between these taxes for which presently no deduction may be claimed and the other taxes which may be deducted if they represent expenses of a business or in the production of income, your committee's bill adds a new section (sec. 275) providing that no deduction, at all, may be taken for certain specified taxes. The taxes listed in this section are listed as exceptions in section 164 of the code under present law, and are moved to the new location in the code merely to emphasize the fact that these taxes cannot in any event be claimed as a deduction.

These taxes are as follows:

1. Federal income taxes;
2. Federal war profits and excess profits taxes; and
3. Estate, inheritance, legacy, succession, and gift taxes;
4. Income, war profits, and excess profits taxes imposed by a foreign country or a possession of the United States if the taxpayer chooses to take a foreign tax credit with respect to these taxes; and
5. Taxes on real property which the code requires to be treated as being imposed on another taxpayer.

(c)(ii) *Definitions of certain deductible taxes.*—Your committee's bill defines a personal property tax which may be deducted as an ad valorem tax imposed on an annual basis in respect of personal property.

A general sales tax is defined as a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. The bill specifies, however, that the fact that food, clothing, medical supplies, and motor vehicles either are exempt from a sales tax or are taxed at a lower rate is not to result in any given tax being classified as not applying to a "broad range of classes of items." However, if any of these specified items are taxed at a higher rate than the general rate applying to other items, or if any other item is taxed at a different rate, no deduction is to be permitted for the tax on these items.

As under present law, deductions may be taken for general sales taxes not only where they are imposed on the consumer as such, but also where they are separately stated and where the tax is in fact paid by the consumer.

Included in the definition of a deductible general sales tax by your committee's bill is a "compensating use tax." A compensating use tax, as its name implies, is generally a tax imposed on items brought in from another taxing jurisdiction. In this case, the tax is imposed on the "use, storage, or consumption of the item" since the sale as such does not occur in the taxing jurisdiction in question. For such a tax to be deductible, similar items must be subject to a deductible general retail sales tax in the taxing jurisdiction in question.

(*c*)(*iii*) *Certain local improvement taxes.*—Under present law, local improvement taxes generally are not deductible (although interest or maintenance charges may otherwise be deductible). However, presently an exception is made and a deduction is permitted for local improvement taxes levied by a special taxing district where the district covers at least one entire county, at least 1,000 persons are subject to the tax levied by the district, and the district levies its assessment annually at a uniform rate on the same assessed value for real property as is used generally for purposes of the real property tax. This deduction is of quite limited application and your committee believed that provision for such deductions is no longer desirable. Accordingly, the bill deletes the provision which grants this deduction.

(*c*)(*iv*) *Effective date.*—The changes made by the above provisions relating to taxes apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—The changes made by this section in the deduction of taxes are expected to increase revenues by $520 million in a full year of operation.

8. Personal casualty and theft losses (sec. 208 of the bill and sec. 165(c)(3) of the code)

(*a*) *Present law.*—Under present law, taxpayers may claim a deduction for losses of property not connected with a trade or business if these losses arise from fire, storm, shipwreck, or other casualty, or from theft. Under present law, these deductions are available without limitation to all taxpayers who itemize their personal deductions.

In addition, under present law, losses incurred in a taxpayer's trade or business or losses incurred in connection with transactions entered into for profit are deductible. The change made by this bill with respect to casualty losses described below does not affect the continued

full deduction of these losses as business expenses or as expenses incurred in the production of income.

(*b*) *General reasons for provision.*—Your committee believes that in the case of nonbusiness casualty and theft losses, it is appropriate in computing taxable income to allow the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. In view of this, your committee believes that it is appropriate to limit the casualty loss deduction to those losses or thefts above a minimum amount. The minimum selected by your committee was $100 per casualty loss, since this corresponds approximately with the "$100 deductible" insurance carried by many individuals in the United States with respect to such losses. This means that no deduction will be allowed in the case of an ordinary "fender bending" accident or casualty, but that casualty and theft losses will continue to be deductible (over the $100) in those cases where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes.

(*c*) *General explanation of provision.*—The amendment made by your committee's bill limits the deductibility of personal losses (as distinct from those associated with a trade or business or transactions entered into for profit) to those where the casualty or theft loss exceeds $100. For this purpose, in determining what is a single casualty, it is intended that the law be interpreted liberally. Thus, for example, where an individual's property is damaged by wind from a hurricane and this is followed by additional damage resulting from water, it is intended that the combination of these events be treated as one casualty and, therefore, that all amounts over $100 of damage be deductible.

The $100 limitation applies to a joint return by a husband and wife as well as to a separate return of either. Thus, if a husband and wife file separate returns, each is subject to a separate $100 floor with respect to each casualty or theft, while, if they file a joint return, they are together subject to only one $100 floor with respect to each casualty or theft whether the loss is sustained with respect to jointly, or separately, owned property.

(*c*)(*i*) *Effective date.*—This amendment applies to losses sustained after December 31, 1963.

(*d*) *Revenue effect.*—It is estimated that this provision will increase revenues by $50 million a year in a full year of operation.

9. Charitable, etc. contributions, and gifts (sec. 209(a) of the bill and sec. 170(b) of the code)

(*a*) *Present law.*—Under present law, individuals are allowed a deduction of up to 20 percent of their adjusted gross income for contributions to or for the use of charitable, educational, religious, etc., organizations generally. An additional 10-percent deduction also is available for contributions to churches, schools, hospitals, certain medical research organizations, and certain organizations affiliated with State colleges or universities. Thus, with respect to contributions in this latter category, a charitable contribution deduction of up to 30 percent is allowed.

(*b*) *General reasons for provision.*—Your committee believes that the availability of this additional 10-percent deduction should be

extended to include contributions to many forms of charitable or philanthropic organizations not now covered by this provision. Your committee has concluded that greater uniformity in the availability of this additional 10-percent deduction is desirable because of the many beneficial activities that are carried on by various philathropic organizations not now eligible for the 30-percent deduction. This is especially true of many cultural and educational organizations and major charitable organizations not now eligible for the 30-percent deduction.

Your committee is limiting the additional 10-percent deduction to organizations which are publicly or governmentally supported, however, and is not making this additional deduction available in the case of private foundations. These latter types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.

(c) *General explanation of provision.*—For the reasons given above, your committee's bill provides that the additional 10-percent deduction (or 30-percent deduction in total) from a taxpayer's adjusted gross income is to be extended so that it not only is available with respect to charitable contributions to churches, schools, hospitals, etc., but also is available generally in the case of charitable contributions to religious, charitable, scientific, literary, or educational organizations or those for the prevention of cruelty to children or animals (which otherwise meet the conditions set forth in sec. 170(c)(2) of the code). In addition, the 30-percent deduction is to be available for charitable contributions to a Federal, State, or local governmental unit if the contribution or gift is made for exclusively public purposes.

For any of the nongovernmental organizations to qualify for the additional 10-percent deduction referred to above, they must normally receive a substantial part of their support from a governmental unit or from direct or indirect contributions from the general public. "Support" for this purpose does not take into account income received by the organization from exercise of its exempt function. The reference to direct or indirect contributions from the general public prevents what are generally termed private foundations from qualifying for this additional 10-percent deduction. To qualify, the organization must receive support from at least a representative number of persons within the community concerned.

Types of organizations which generally will in the future qualify for this additional 10-percent deduction are those publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama, and organizations such as the American Red Cross, United Givers Fund, etc.

(c)(*i*) *Effective date.*—This provision applies to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible revenue loss when fully effective.

10. Five-year charitable contribution carryover for corporations (sec. 209(b) of the bill and sec. 170(b) of the code)

(*a*) *Present law.*—Under present law corporations are allowed a maximum charitable contribution deduction of 5 percent of their taxable income computed without regard to this deduction (and certain other deductions). Any charitable contribution deductions which exceed this maximum may be carried forward and used in the 2 following years to the extent the maximum limitations for those years permit. In the case of tax-free reorganizations, generally, and in the case of the liquidation of a subsidiary, the present law provides that the 2-year charitable contribution carryover, to the extent not used by the prior corporation, is to be available to the acquiring corporation.

(*b*) *Reasons for provision.*—The attention of your committee has been called to situations where corporations have income which varies widely from year to year with the result that in some years they have losses and in other years income. This presents a problem where these corporations have committed themselves to the making of specific annual contributions to local charitable organizations. This frequently is done because of the importance to the local charity of maintaining a relatively stable budget from year to year. However, from the standpoint of the corporation the 5-percent limitation on charitable contributions means that the benefit of the charitable contribution deduction is lost in loss years, or in low income years, unless income is sufficiently high in the 2 immediately following years to not only permit the deduction of the amount carried forward but the usual charitable contributions for those years as well. Frequently this is not a sufficient length of time to enable the full deduction of charitable contributions in such cases.

(*c*) *General explanation of provision.*—In view of the above considerations your committee's bill substitutes for the 2-year carryforward of unused charitable contributions available in present law a 5-year charitable contribution carryforward for corporations. The amount which may be carried forward in such cases is the amount of the charitable contributions in excess of the amount which may be deducted within the 5-percent limitation. In the year to which the charitable contributions are carried the charitable contributions of that year are applied first, and then the charitable contributions carried forward with the oldest year from which a charitable contribution is carried forward being applied first. Any unused charitable contributions are carried forward to succeeding years, but if not used up after a 5-year carryforward period, they no longer are available for further deduction.

The 5-year charitable contribution deduction carryover is also made available to acquiring corporations in tax-free reorganizations and to parent corporations in the case of the liquidation of a subsidiary. The acquiring corporation in these cases treats the carryforward of the charitable contribution in the same manner as if it were its own unused charitable contribution being carried forward to the current year.

(*c*)(*i*) *Effective date.*—The 5-year carryforward is to be effective with respect to contributions paid (or treated as paid) in taxable years beginning after December 31, 1963. Thus, a charitable con-

tribution made in 1964 would be the first charitable contribution with respect to which the 5-year, as distinct from the 2-year, charitable contribution carryforward would be available.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue when fully effective.

11. Limitation on charitable contribution deduction for future gifts of tangible property (sec. 209(c) of the bill and sec. 170(f) of the code)

(*a*) *Present law.*—Under present law, if a taxpayer gives property to charity but retains for either his or someone else's life or any other period the use or enjoyment of the property, he receives a charitable contribution deduction for income tax purposes at the time of the gift of the future interest in an amount equal to the present discounted value of that future interest.

(*b*) *General reasons for provision.*—The attention of your committee has been called to cases where pictures or art objects are given to museums, but the gift takes effect at some future time, usually based upon the life of the contributor or someone else. In the meanwhile, the use of the pictures or art objects is retained in much the same manner as if the contribution of the future interest had not been made. The same enjoyment would occur, for example, if instead of making a gift of a future interest, the taxpayer were to wait until his, or his family's, use of the property was completed. If this use was completed at the time of his death, however, no charitable contribution for income tax purposes could be claimed even though an estate tax deduction would be available.

Your committee believes that it is inappropriate generally for taxpayers using this device to obtain what amounts to an extra charitable contribution deduction for income tax purposes. However, it is also recognized that in the ordinary case where the contributor retains the right to use the property for his own life that this in fact has been a strong inducement for giving pictures and art objects to museums and other cultural centers in the United States. Moreover, much of the problem which has arisen in the past has stemmed from the problem of valuing the pictures and art objects given. It is understood that the Treasury Department has had discussions with respect to the manner of valuing these gifts and that more reasonable valuations can be expected in the future.

In view of these considerations, your committee has in effect postponed the time of taking a charitable contribution deduction until the gift is completed, but has made this inapplicable where the only reservations relate to the life or lives of the contributor or contributors.

(*c*) *General explanation of provision.*—For the reasons indicated above your committee's bill in certain cases provides that charitable contributions in the form of a future interest in tangible personal property are to be treated as deductible for income tax purposes only when all interests in, and rights to possession or enjoyment of, the property in question has been given up. This new rule, however, is not to apply in the case of charitable contributions where the only reservation in the gift is that the property is not to be transferred until the death of the contributor (or in the case of joint gifts by husband and wife may not be transferred later than the death of whichever dies later). In cases where the reservation is for the life of the contributor or contributors, a charitable contribution deduc-

tion will continue to be available at the time of the gift of the future interest, but as under present law the amount of the contribution in this case is to be only the present value of the future interest.

Any other type of a reservation by the contributor and any reservation in the hands of related persons described in section 267(b) of the code will result in a denial of the charitable contribution deduction as long as the reservations continue.

Although generally this provision is limited to gifts of future interests in tangible personal property the provision also covers fixtures which are intended to be severed from the real property; such as chandeliers, mantels, etc.

(c)(i) *Effective date.*—This provision applies to transfers after December 31, 1963.

(d) *Revenue effect.*—This provision is expected to result in a negligible revenue gain when fully effective.

12. One percent limitation on medicines and drugs for those over age 65 (sec. 210 of the bill and sec. 213 of the code)

(a) *Present law.*—Under present law, generally only what are considered abnormal medical expenses are deductible. This result is attained by limiting expenses which may be deducted to the excess of these expenses over 3 percent of the individual's adjusted gross income (income after business and similar expenses but before personal exemptions and personal expenses). In computing medical expenses subject to this 3-percent limit, medicines and drugs may be taken into account only if they exceed 1 percent of adjusted gross income. The 3-percent limitation does not apply in the case of the taxpayer and his spouse where either of them is 65 or over nor does it apply in the case of medical expenses of the mother or father of the taxpayer or of his wife where the parent is 65 or over and receives his principal support from the taxpayer. The 1-percent limitation on medicines and drugs, however, applies to everyone without regard to their age.

(b) *General reasons for provision.*—Your committee's bill repeals the 1-percent limitation with respect to medicines and drugs insofar as it relates to a taxpayer, or his spouse either of whom is age 65 or over, or to the parent of the taxpayer (or his spouse) where the parent is a dependent of the taxpayer and is 65 or over. The effect of this is to provide that the 1-percent limitation will apply only in those cases where the 3-percent limitation also applies. Your committee has taken this action because it believes that it is undesirable to impose any minimum limitation with respect to the deductibility of medical expenses in the case of the aged. It also believes that conforming the application of the 1-percent limitation with the 3-percent limit will simplify the statute somewhat in this area.

(c) *General explanation of provision.*—Present law provides that medicines and drugs which otherwise would be taken into account in computing medical expenses (which are either deductible in whole, or to the extent they exceed 3 percent) are to be deductible only to the extent that the total of these medicine and drug expenses exceed 1 percent of the taxpayer's adjusted gross income. Your committee's bill makes this 1-percent limitation inapplicable in the case of amounts paid for the care of the taxpayer and his spouse if either of them has attained age 65 before the end of the taxable year. It also provides

that this 1-percent limitation is not to apply to amounts paid for the care of a dependent mother or father of the taxpayer or his spouse if the mother or father has attained age 65 before the end of the year and also is a dependent of the taxpayer. Thus neither the 3-percent limit on medical expenses generally nor the 1-percent limit on medicines and drugs will apply to the categories of persons specified above who are age 65 or over. The maximum limitations on medical expenses, however, continue to apply to these and other persons in the same manner as under existing law.

(c)(i) *Effective date.*—This provision is to apply to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—This provision is expected to result in a revenue loss of $10 million in a full year of operation.

13. Care of dependents (sec. 211 of the bill and sec. 214 of the code)

(a) *Present law.*—Under present law, a deduction of up to $600 is allowed in certain cases for expenses of child care incurred to enable a taxpayer to be gainfully employed. At present, this is available for single women, women who are divorced or separated, or in some cases, deserted, and widows and widowers, having one or more dependents without regard to the amount of the taxpayer's earnings. In the case of working wives, the $600 deduction is presently available only if the combined adjusted gross income of the wife and husband (who must file a joint return) does not exceed $4,500. If their income exceeds this amount, the deduction available is decreased $1 for each dollar of income above $4,500, thus disappearing entirely at an income level of $5,100. An exception to this rule provides that this income limitation is not to apply if the husband is incapable of self-support because mentally or physically defective.

A dependent of the taxpayer for whom this $600 may be claimed must be a son or daughter (or stepson or stepdaughter) of the taxpayer who is under age 12 or a dependent who is physically or mentally incapable of caring for himself.

(b) *General reasons for provision.*—Your committee has concluded that the deduction presently available for the expenses of child care and other dependents who are unable to look after themselves is too restrictive. One example of this is a family where the wife is either in an institution or physically or mentally incapable of caring for herself. Under present law, if the husband is incapable of self-support because of mental or physical deficiences, the wife is fully eligible for the deduction without regard to the family income level. Certainly a family where the wife is in an institution is at least as likely to incur expenses for child care as a family where the husband is incapable of self-support. Similarly, child care expenses are likely to be required, where the wife is in the home but not capable of caring for herself. In these cases, your committee's bill extends present law to permit child care expenses, subject to limitations, to be deducted.

As previously indicated, the maximum amount which may be deducted under present law is $600 per year per taxpayer. A flat limitation of this type fails to take into account the fact that costs of caring for dependents, particularly where they must be cared for outside of the home, increases as the number of dependents increases.

Your committee's bill, therefore, gives a limited recognition to this factor by raising the maximum deduction in certain cases up to $900 where the taxpayer has two or more dependents.

In addition, your committee has concluded that limiting this deduction to children of the taxpayer who are under age 12 (except in in the case of those mentally or physically incapable of caring for themselves) is too low an age limit; therefore, your committee's bill raises this age limit to cover the care of children under 13 years of age.

(*c*) *General explanation: Incapacitated and institutionalized wives.*—This bill adds to the list of situations where the deduction may be claimed those cases where a wife is incapacitated or institutionalized. For the husband to be eligible for the deduction, the wife must be institutionalized or incapacitated for 90 consecutive days (or a shorter period if she dies). In the case of incapacitated wives, the deduction is fully available only where the adjusted gross income of the taxpayer and his spouse does not exceed $4,500 (for incomes above that level, the deduction decreases $1 for each dollar of income above $4,500). The $4,500 limitation does not apply, however, if the taxpayer's wife is institutionalized for a period of 90 days or more. A wife is considered as being incapacitated if she is incapable of caring for herself because she is mentally or physically defective (including any time she is institutionalized). A wife is considered institutionalized while she is receiving medical care or treatment as an inpatient, resident, or inmate of a public or private hospital, sanitarium, or similar institution.

(*c*)(*i*) *General explanation: Raising the deduction to $900 in certain cases.*—Under present law, as previously indicated, the maximum annual deduction which may be claimed by anyone is $600. Your committee's bill, where there are two or more qualified dependents, raises this maximum deduction which may be taken, for expenses incurred by the taxpayer, to $900. The additional $300 is not to be available, however, to a working wife (unless her husband is incapable of self-support because defective) even though combined income of the husband and wife does not exceed $4,500.

(*c*)(*ii*) *General explanation: Raising the age limit for children to 13.*—Present law provides that a dependent, for purposes of the deduction (if not physically or mentally incapable of caring for himself) must be a son or daughter (or stepson or stepdaughter) of the taxpayer who has not attained the age of 12. Your committee's bill raises this age limit to 13.

(*c*)(*iii*) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—It is anticipated that this provision, in a full year of effect, will result in a revenue loss of $5 million.

14. Moving expenses (sec. 212 of the bill and sec. 217 of the code)

(*a*) *Present law.*—Under present law, certain moving expenses of existing employees if reimbursed by the employer are held to be excludable from the employee's income. They have been ruled excludable on the ground that they are incurred "in the interest of the employer" (Rev. Rul. 54–429, C.B. 1954–2, 53).

Under present law, the moving expenses (for moving from one official station to another for permanent duty) which the Internal

Revenue Service has agreed are excludable for existing employees where they are reimbursed are:

1. Transportation expenses for moving the employee and his family;
2. Transportation and certain related costs of moving the personal and household effects of the employee and his family; and
3. Expenses incurred for meals and lodging for the employee and his family while they are en route to their new location.

In addition, in two court cases, taxpayers have been permitted to exclude other types of moving expenses, although the Internal Revenue Service has not acquiesced in the exclusion of these other types of moving expenses.[1]

On the other hand, reimbursements for moving expenses received by new employees from their employers are includible in gross income. Moreover, no deduction is allowed for moving expenses of any employee with respect to expenses for which no reimbursement is received.

(*b*) *General reasons for provisions.*—Your committee believes that the existing tax treatment of moving expenses needs modification because the present treatment discriminates against both new employees and employees who are not reimbursed for their moving expenses by their employers. Your committee sees no reason why new employees should include in their income amounts representing moving expenses which, if received by an existing employee who is moved by his employer from one location to another, would be excludable from income. Neither does your committee see any reason for discriminating against those employees who are not reimbursed for their moving expenses, but who incur such expenses in seeking job opportunities. Your committee believes that it is important to remove deterrents to the mobility of labor. Anything which can be done in this respect should aid in reducing local structural unemployment.

Your committee's bill limits the categories of expense for which a deduction is available to new employees or those who are not reimbursed for moving expenses to the three categories specified above, which, by ruling, the Internal Revenue Service recognizes as excludable for existing employees. No inference should be drawn from this, however, that moving expense exclusions under existing law are necessarily limited to these three categories of expenses. However, since by administrative ruling, these categories are clearly excludable in the case of existing employees who are reimbursed, your committee believed that deductions for such expenses should also be made available to new employees and nonreimbursed employees as well. The question of whether the exclusion for existing employees extends beyond these three categories is left for judicial interpretation.

(*c*) *General explanation of provisions.*—The deductions allowed by your committee's bill with respect to moving expenses are to be deductible in computing "adjusted gross income." This means that these expenses are treated essentially the same as business

[1] In *John E. Cavanagh* (36 T.C. 300; 1961) it was held that living costs incurred by the employee in excess of ordinary living expenses of his family were excludable where they were reimbursed while his household effects were in transit. In *Otto Sorg Schairer* (9 T.C. 549; 1947) it was held that where an employee was reimbursed for a loss incurred in selling his home this reimbursement was an addition to the sales price. More recently, however, the Tax Court held that reimbursements of similar expenses were additional compensation and not excludable from the employee's income in the case of *Harris W. Bradley* (39 T.C. 652; 1963). A reimbursement on sale of a house was also held to be compensation in *Arthur V. Kobacker* (37 T.C. 882; 1962).

expenses; these expenses, therefore, are deductible whether the individual involved itemizes his personal deductions or takes the standard deduction. This treatment is provided not only because these expenses are substantially similar to business expenses, but also because when they are incurred, they are likely to be relatively large. In such cases, it occurred to your committee that it would be undesirable to, in effect, make taxpayers choose between taking this deduction and the standard deduction in lieu of itemized personal deductions.

No deduction is provided under this provision for moving expenses for which the taxpayer receives reimbursements which are not included in his gross income. Thus, existing employees may continue to exclude reimbursed moving expenses from their gross income in the same manner as under present law. Their status, in this regard, is left entirely unchanged.

The types of moving expenses which may be deducted under this provision are reasonable expenses for—

1. Moving household goods and personal effects from the former residence to the new residence;
2. Transportation expenses of the employee and his family from the former residence to the new place of residence; and
3. Expenses for meals and lodging while in transit from the former residence to the new place of residence.

The moving expenses referred to are available not only with respect to the taxpayer, but also to any other members of the taxpayer's household who had as their permanent place of abode the taxpayer's former residence and moved to his new residence.

(*c*)(*i*) *Limitations.*—To prevent the deduction of moving expenses for short moves, the bill provides that, for a deduction to be available, the taxpayer's new place of work must be at least 20 miles farther from his former residence than was his former place of work. In other words, his commuting distance must have increased by at least 20 miles to be eligible for this deduction. If the individual involved previously had no place of work, his new work location must be at least 20 miles from his former residence.

To prevent individuals from taking temporary jobs in order to obtain the deduction of moving expenses, the bill provides that during the 12-month period immediately after the individual's arrival at his new principal place of work, he must be a full-time employee in that general location for three-fourths of the time (39 weeks). This limitation, however, is not applied in any case where the individual is reimbursed for his moving expenses by his employer since, presumably, an employer would not reimburse such expenses even for a new employee unless it was his intention that the individual remain employed for an extended period of time.

This requirement that an employee be a full-time employee in a general location for three-quarters of a year after moving means that where he has moved after the first half of the year, he cannot be sure when he files his return in the following April that he will meet this 9 months' requirement. For that reason, the bill permits the employee in such a case to claim the moving expense deduction (assuming he has not already disqualified himself by that time, such as by moving out of the general location). Then, if after filing his return he fails to qualify for the moving expense deduction by not remaining

employed full time for 39 weeks in the new location he is to include in his gross income for the following year the amount of moving expense deduction claimed in the prior year.

(c)(ii) *Effective date.*—The new treatment provided by this provision applies to expenses incurred after December 31, 1963.

(d) *Revenue effect.*—It is anticipated that this provision in a full year of operation will result in an annual revenue loss of $60 million a year.

15. Interest on loans on certain insurance and annuity contracts (sec. 213 of the bill and sec. 264 of the code)

(a) *Present law.*—Under existing law, no interest deduction is allowed in the case of indebtedness incurred or continued to purchase, or carry, a single premium life insurance, endowment, or annuity contract. In addition, if substantially all the premiums on a contract are paid within 4 years of the date on which the contract was purchased, the contract is treated as if it were a single premium contract for purposes of this provision. Similarly, where a purchaser borrows an amount equal to a substantial portion of the premium payments on a contract, but, instead of purchasing the policy outright, deposits the borrowed funds with the insurance company for future payments on a policy, this also is treated as if it were a single premium contract and the interest deduction on the indebtedness relating to the contract is denied. However, under present law, no interest deductions are denied where the taxpayer purchases an insurance contract with the intention of borrowing the maximum amount on the contract each year, unless the contract falls in one of the categories described above.

(b) *General reasons for provision.*—The attention of your committee has been called to instances where life, or other, insurance policies have been sold to individuals on the basis that they cost the individual little or nothing, and in some cases on the grounds that they actually result in a net profit for him. In such cases, the taxpayer each year borrows all, or a substantial part, of the funds necessary to pay the premium on the policy. If he is in a 50 percent (or higher) tax bracket, since the interest payments on such loans are presently deductible, the net interest cost to him is one-half or less of the interest payments he makes. The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured. Because of this, some insurance companies have sold insurance policies under plans which provide for the taxpayer borrowing the premiums either directly from the insurer, or from a bank or otherwise, primarily on the grounds that the policies are tax-saving devices. Your committee doubts that the sale of insurance on such a basis is either desirable or fair to taxpayers generally.

Your committee recognizes, however, the importance of being able to borrow on insurance policies; and, therefore, while adopting a provision designed at minimizing the sale of insurance as a tax-saving device, it has been careful in this provision to provide for the reten-

tion of rights to borrow on insurance for other than tax-saving purposes without the loss of the interest deduction.

One of the Treasury's proposals on which the committee took no action, involving the tax treatment of split-dollar life insurance arrangements, is closely related to this bank loan insurance provision. These are arrangements entered into jointly by an employer and employee under which part of the premiums on a life insurance policy are paid by each. Your committee believed that the issues involved in this problem, and the proper solution, including the possibility of administrative action, are in need of further study by the Treasury Department.

(c) *General explanation of provision.*—Your committee's bill provides that interest paid on indebtedness incurred or continued to pay premiums on life insurance contracts, endowment contracts, or an annuity is not to be deductible if the individual is following a plan of systematically borrowing amounts equal to the increase in the cash value of the insurance contract to pay part or all of the premiums. The interest deduction is to be denied whether the borrowing is direct or indirect; that is, whether it is from the insurance carrier, from a bank, or from any other person. It also is intended to cover cases where the individual borrows on other property or on his general line of credit to pay the premiums. This provision is not to apply to a single premium contract or to a contract treated like a single premium contract, since present law already denies a deduction in these cases.

In effect, where the taxpayer systematically borrows the increase in the cash value of his policy he is converting what generally is a permanent form of life insurance into substantially the equivalent of renewable term insurance. In this case, however, he retains the right to restore the contract to permanent insurance as of the original age at which he took out the contract by repaying the amount borrowed from the insurance company, bank, or other person.

Your committee's amendment applies only to insurance or annuity contracts purchased after August 6, 1963, the date your committee first announced its action on this matter. Thus, even in the future, your committee's action will have no effect on contracts already held by individuals and therefore it will not interfere with plans already established.

(c)(i) *Exceptions.*—Your committee desired to be sure that the value of insurance generally would not be decreased by reducing the rights of the individual to borrow on the insurance, as he can in the case of other forms of assets. For this reason, your committee has added a number of exceptions to the general rule, where, even though the borrowing may take the form of a systematic plan, nevertheless this provision is not to apply. These exceptions are as follows:

1. The interest deduction is to be allowed if there is no borrowing with respect to any four of the annual premiums payable on the insurance or annuity contract in the first 7 years of the contract. However, to prevent avoidance of this provision by taking out a contract with very low premiums for the first 4 years, with the premiums being substantially greater thereafter, the bill contains a rule relating to to above is to commence again at any time there is a substantial increase in the premiums payable under the insurance or annuity contract.

2. A de minimis rule is to apply. Thus, if the otherwise nondeductible interest of an individual with respect to an entire taxable year does not exceed $100, no interest deduction will be denied.

3. In any event, no interest deduction will be denied if the debt was incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in financial obligations. Thus, for example, the interest deduction would not be denied where the individual systematically borrowed on a policy previously purchased because he, or his family, incurred large unforeseen medical bills or because he unexpectedly lost a substantial income source.

4. The interest deduction is not to be denied where the indebtedness actually is to finance business obligations, rather than to carry insurance. For example, an individual with an insurance policy would not have his interest deductions denied where it can be shown that the amounts borrowed by him were actually used to finance the expansion of inventory or for other similar business needs.

(*c*)(*ii*) *Effective date.*—This provision applies to amounts paid in taxable years beginning after December 31, 1963, but only with respect to policies purchased after August 6, 1963.

(*d*) *Revenue effect.*—It is estimated that this provision will result in an annual revenue gain of $5 million in 1964 and 1965 and $10 million when the provision is fully effective.

16. Employee stock options and purchase plans (sec. 214 of the bill and secs. 421–425 of the code)

(*a*) *Present law.*—Under present law, no income tax is imposed in the case of employee restricted stock options, either when the option is granted or at the time it is exercised. Instead, tax generally is imposed at the time the stock involved is sold by the employee. In the case of those stock options where the option price is at least 95 percent of the market price of the stock at the time the option is granted, the entire amount of any gain realized by the employee at the time he sells the stock is treated as capital gain. Where the stock option price is between 85 and 95 percent of the market price at the time the option is granted, the difference between the option price and the market value of stock at the time of the grant of the option is treated as ordinary income. However, this ordinary income is not realized for tax purposes until the employee sells the stock.[1] Any additional gain at the time the stock is sold in such cases is treated as capital gain. In the case of these restricted stock options, employers are not allowed any deduction for the amount of the gain realized by the employee, whether this gain is treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must be at least 85 percent of the market price of the stock at the time the option was granted, the stock and/or the option must be held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it is transferred to him, the option must not be transferable other than at death, the individual may not be a 10-percent shareholder in the corporation (unless the option price is at least 110 percent of the fair market value) and the option must not be for a period of more than 10 years.

[1] If the gain is less than the spread between the option price and the fair market value at the time the option is granted, this lesser amount is taxed as ordinary income.

(*b*) *General reasons for provisions.*—The administration recommended the repeal of the stock option provision altogether. This recommendation was made on the grounds that stock options were compensatory in nature and, therefore, should be treated in the same manner as wages and salaries. It was suggested that with the lower tax rates provided by this bill, compensation received in this manner no longer required special treatment.

Your committee, however, decided to continue the stock option provision because it believes that it is good for the economy for management of various businesses to have a stake in their successful operation. Your committee believes that this provides important incentives to expand and improve the profit positions of the companies involved. This is not only good for the specific businesses involved, but also for the economy as a whole. Despite the fact that your committee is continuing the stock option provision, however, it has recognized, as did many business executives who appeared before your committee in its hearings, that there are abuse situations in the present provisions which need correcting. Your committee's bill directs its attention toward such corrections.

Although the use of stock options generally is thought of in terms of providing incentives for key executives in a business, what are presently called restricted stock options also are used by some companies for an entirely different purpose. Some companies have made stock options available to all, or practically all, of their employees. Taking advantage of the fact that the option may be granted at 85 percent of the market price they make discount sales of the stock to their employees generally. These are known as employee stock purchase plans. Where stock options are used in this manner, they are designed primarily as a means of raising capital; and, in such cases, the discounts from market price made available to the employees usually correspond approximately with the costs the company would otherwise incur in floating a new stock issue.

In practice, your committee found that quite different features are required for key employee stock option and the discount purchase plans made available to employees generally. For that reason, it has separated the two types of options into separate sections setting forth substantially different requirements for each. In the case of the key employee stock options or "qualified stock options" as they are called by the bill for future years—

1. The period over which the stock must be held has been increased to 3 years. This is designed to give assurance that the key employees actually are acquiring a "stake in the business" and are not merely turning the stock over as fast as the options can be exercised.

2. The maximum period of time over which an option may be outstanding has been reduced from 10 years to 5. It is recognized that stock options historically have a much greater value to the individual if the period of time over which they may be exercised is a long period, since over most 10-year periods stock values have risen. Thus, where the option may be exercised over a very long period of time, such as 10 years, its grant appears more closely associated with compensation and less directed toward the individual efforts of the employee involved. Furthermore, the purpose of the provisions is to encourage the acquisition of a proprietary interest in the business as quickly as possible.

3. The options must be issued at 100 percent of the market price rather than 85 percent (with a special rule where the price inadvertently is set below 100 percent). Closely associated with this also is the removal of the variable price stock option provision. These modifications are made to decrease the compensatory nature of the existing stock option provision and to place greater emphasis on the employee's efforts to improve his company's business and thereby raise the price level of the stock.

4. Provisions have been added to limit the extent to which new options may be exercised where old options previously were issued, but had become less attractive than a new option because of a decline in the market price of the stock in the interval between the issuance of the two. Existing law already limits the resetting of options below the original price of issue where the stock has declined. This modification achieves the result intended, but not obtained, by existing law.

5. Stockholder approval is required for stock option plans to give assurance that the benefits granted management in the case of these options is in accordance with the desires of the stockholders.

6. The bill also provides that stock options generally are not to be made available to employees with stockholdings of more than 5 percent (although to a limited extent, they may be made available in the case of small business to those with holdings up to 10 percent). Under present law, stock options may be granted to employees with stockholdings of more than 10 percent only at a price 10 percent above the market price. It was thought unnecessary to provide employees who are substantial stockholders with any incentive to improve the business since they already have a substantial stake in its successful operation.

In the case of the employee stock purchase plans, existing law is continued (in a separate section) without major modification. In this case, for example, employees will continue to be able to purchase stock through options at a price as low as 85 percent of the market price of the stock at the time the option is issued since these plans, as previously indicated, are in the nature of "discount" purchase plans. However, to qualify for treatment under the employee stock purchase plans, a series of new conditions must be met designed primarily to establish that the purchase plans are made available without discrimination to most employees of the corporation.

(c) *General explanation of provisions.*—The bill divides the tax treatment of employee stock options and purchase plans into five provisions: First are the general rules applicable to both; second, the special rules applicable to qualified stock options (i.e., those for key employees which are granted after June 11, 1963); third, the special rules applicable to employee stock purchase plans (in general, those granted after June 11, 1963); fourth, restricted stock options (which cover both of the two categories mentioned immediately above but only for options issued before June 11, 1963); and fifth, certain definitions and special rules applicable to stock option and stock purchase plans in both the past and the future. The material presented below deals first with qualified stock options and then with employee stock purchase plans. The provisions dealing with restricted stock options, which are only those options issued in the past,

are covered by a continuation of existing law and are not dealt with here.

(c)(i) *Qualified stock options: tax treatment.*—Generally, in the case of qualified stock options, no income tax is imposed either at the time the option is granted or at the time the option is exercised and the stock is transferred to the employee. Similarly, no business expense deduction is allowed to the employer corporation (or a parent or subsidiary of that corporation) at any time with respect to this option.

There is, however, an exception to the general rule that no tax is imposed at the time of the exercise of the option. As is indicated below, one of the requirements of a qualified option is that the price under the option is not to be less than the fair market value of the stock at the time the option is granted. An exception to this, however, is provided where there was an attempt made in good faith to price the option at the market value of the stock but the market value was underestimated. This, of course, would ordinarily occur in the case of unlisted stock. In such cases the option will not be disqualified, but 1½ times the difference between the option price and what actually is the fair market value of the stock at the time the option is granted (or the difference between the option price and fair market value at the time of exercise, if this is smaller) is to be taxed as ordinary income at the time the option is exercised. This is intended to discourage any attempts at undervaluing the stock, without disqualifying the options where the undervaluation was unintentional.

Another limitation on a qualified stock option (set forth below) is that the stock must be held for at least 3 years. The bill provides that in those cases where it is not held for this 3-year period, the option will still be a qualified option, but the spread between the option price and the value of the stock at the time the option is exercised will be treated as ordinary income at the time the stock is sold. However, in such cases the employee will never be taxed on more than his gain. Thus, if the price of the stock has fallen since the time of the exercise of the option, the amount of the ordinary income will be limited to the difference between the option price and the actual price of the stock on the date of sale. Where the price of the stock at the time of sale is less than the option price, there will be no ordinary income and the difference between the option price and the price at which the stock is sold will be treated as a capital loss. On the other hand, if the stock is sold at a price which is higher than the price on the date the option was exercised, then in addition to the amount treated as ordinary income (the difference between the option price and value on the date of exercise) there will be an amount treated as a capital gain.

The determination of the type of capital gain, i.e., whether short-term, class B or class A, will depend on the length of time the stock has been held. Thus, any gain where the stock has been held beyond the 3-year period specified with respect to qualified stock options will result in class A gain with a 40 percent inclusion factor and a 21 percent maximum tax. Where the stock is disposed of in less than 3 years and, in addition to the amount treated as ordinary income, there is an amount treated as capital gain, this capital gain will be either short-term (if the stock is held 6 months or less) or class B (if it is held more than 6 months but not more than 2 years).

As under present law, where the employee dies after having purchased the stock but before holding it for the specified period of time, this holding period is waived since there is no business reason for requiring the estate or heir to hold the stock. Similarly, a requirement subsequently referred to that the individual must be in the employ of the corporation involved up to 3 months before the date of exercise of the option also is waived in the case of the death of the employee before exercise.

A transfer to a trustee in bankruptcy (or a similar fiduciary) of shares of stock acquired under a qualified stock option is not considered to be a "disposition" of such share so there will be no ordinary income recognized at that time, although a capital gains tax may be due.

(*c*)(*ii*) *Qualified stock options: conditions for qualification.*—For an individual to receive full qualified stock option treatment, he must not sell (or otherwise dispose of) his stock within 3 years of the date of exercise of the stock option. As indicated previously, where all conditions but this one are met, tax is not imposed until the sale of the stock, but much or all of the tax imposed at that time, if this condition is not met, will be on the basis of ordinary income rather than capital gain. This condition is designed to give assurance that the key executive involved actually maintains a "stake in the business" and is not merely selling the stock shortly after he receives it, thus vitiating the principal purpose of stock options, and converting ordinary compensation into capital gain. This requirement, of course, is not a new idea since present law already requires the individual to hold the option, or stock, for at least 2 years and the stock alone for 6 months in order to receive restricted stock option treatment.

A second condition which must be met for the option to receive qualified stock option treatment is that the individual involved, for the entire time from the date of the granting of the option until 3 months before the date of the exercise of the option, must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) of a corporation which has assumed the option of another corporation as the result of a corporate reorganization, liquidation, etc. This provision differs only slightly from existing law, which requires that the individual be in the employment specified at the time of the granting of the option and on the day ending 3 months before the exercise of the option but does not require that he be in the specified employment in the intervening time. Of course, for this purpose, military leave or sick leave would not disqualify an individual.

In addition to the requirements referred to above, the terms of the option itself must also meet certain specified conditions in order to be eligible for qualified stock option treatment. They are as follows:

1. The option must be granted under a plan which specifies the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.
2. The option must be granted within 10 years of the time the plan is adopted or approved by the stockholders, whichever is the earlier.
3. The option must by its terms be exercisable only within 5 years of the time it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. An exception to this provides that where the option price was less than the market price, but this was unintentional, then this condition is to be considered as met (although as previously indicated, a maximum of 1½ times any difference in price is taxed as ordinary income at the time of the exercise).

5. Generally the option by its terms is not to be exercisable while there is outstanding any qualified stock option or restricted stock option which was granted to the employee at an earlier time. The purpose of this provision is to prevent an individual from indirectly gaining an advantage by in effect resetting the price at which an earlier option was issued by issuing a second option at the lower price. To prevent this a second option may not be exercised during the period the first option under its initial terms could have been exercised unless the first option itself is exercised. Thus, generally a cancellation of the first option will not enable the second option to be exercised any sooner. However, the bill provides that restricted stock options (those granted before June 12, 1963) may be canceled any time before January 1, 1965, without affecting adversely the exercise of a qualified stock option subsequently issued. In addition, in the case of a restricted stock option granted before June 12, 1963, but which under its terms is made available to the employee only in installments over an extended period of time, those installments which cannot yet be exercised at the time of the granting of a new qualified option are not to prevent the exercise of this second option so long as these installments cannot be exercised.

6. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by him. This provision is the same as under present law.

7. The employee immediately before the option is granted must not own stock representing more than 5 percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. In the case of small businesses, however, the employee may own up to 10 percent of the voting power or value of the stock before being disqualified. For a corporation with equity capital of less than $1 million, this percentage is to be 10 percent and for one with equity capital of $2 million it is to be 5 percent. Between these two levels of equity capital the allowable percentage decreases gradually from the 10-percent level for a company with $1 million of equity capital down to the 5-percent level for a corporation with equity capital of $2 million or more. Equity capital for this purpose is the assets of the corporation, adjusted for any change in their basis, less any indebtedness of the corporation. Where a parent or subsidiary also are involved, adjustments are made to delete intercorporate ownership. For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, wife, ancestors, and lineal descendants. Stock owned directly or indirectly by a corporation, partnership, estate, or trust for this purpose is considered as being owned proportionately by shareholders, partners, or beneficiaries.

(*c*)(*iii*) *Employee stock purchase plans: tax treatment.*—As indicated previously, except for the addition of the nondiscrimination requirement (and the requiring of stockholder approval) the tax treatment of

employee stock purchase plans continues to be substantially similar to the tax treatment of restricted stock options under present law. Thus, as under present law, no income is to be reported by the employee either at the time the option is granted or at the time it is exercised. Similarly, no deduction is available to the employer corporation with respect to the employee stock purchase plan.

As under present law, under these purchase plans the option may be issued at a price as low as 85 percent of the market value of the stock at the time of the grant. Where this is done, this spread between the option price and the market value at the time the option is granted, upon the subsequent sale of the stock by the employee is treated as ordinary income. However, in no event is the amount to be taxed to the individual as ordinary income to exceed the gain realized on the stock at the time of its disposition.

In addition, ordinary income in the case of employee stock purchase plans may arise where the stock is disposed of before the expiration of the applicable holding period or is held by the employee at the time of his death. As under present law, the option and/or stock must be held for a period of at least 2 years and the stock itself held for a period of at least 6 months. Where this holding period is not complied with, then any spread between the option price and the price of the stock at the time the option is exercised will be treated as ordinary income when the stock is sold or otherwise disposed of. As under present law, the specified amount is ordinary income without regard to whether this is greater or less than the gain realized on the stock at the time of the sale. Where the gain otherwise realized is less than this amount treated as ordinary income, the specified amount is still treated as ordinary income but a capital loss is recognized equal to the difference between the market value of the stock at the time of exercise and the sales price of the stock. Apart from these two cases where ordinary income may be realized any other gain recognized on the sale of purchase plan stock results in capital gain.

(*c*)(*iv*) *Employee stock purchase plans; conditions for qualifications.*—As indicated above, to qualify for purchase plan treatment, the stock in these cases must not be disposed of within 2 years of the date of the granting of the option nor within 6 months after the transfer of the stock to the individual. This is a continuation of existing law.

In addition, the individual must at all times during the period beginning with the date of the granting of the option and ending 3 months prior to the date of exercise, be an employee of the corporation granting the option, a parent or subsidiary of the corporation, or a corporation (or parent or subsidiary of that corporation) of a corporation which assumed this stock option as a result of a corporation reorganization, liquidation, etc. This provision is the same as that previously described in the case of qualified stock options. As indicated in the case of qualified stock options, this differs only slightly from existing law.

To qualify as an employee stock purchase plan, nine requirements must be met by the plan itself. Alternatively, all but the first two of these may, however, be met in the stock offering rather than the plan. These conditions are as follows:

1. As under present law, the plan must provide that the options are to be granted only to employees of a corporation or a parent or subsidiary.

2. The plan must be approved by the stockholders of the corporation granting the option within 12 months before or after the date the plan is adopted. This provision is a new requirement which is the same as that provided in the case of qualified stock options.

3. No employee can be granted an option if he owns 5 percent or more of the voting power or value of all classes of stock of the employer corporation or parent or subsidiary. Present law provides that employees having more than a 10 percent interest in a corporation may not obtain a restricted stock option at less than 110 percent of the market price of the stock.

4. A new provision designed to prevent discrimination provides that the options must be granted to all employees of the corporation except that there may be excluded one or more of the following four categories:

(*a*) Employees who have been employed less than 2 years;

(*b*) Employees who are part time and employed 20 hours or less per week;

(*c*) Employees whose customary employment is not for more than 5 months a year; and

(*d*) Officers, supervisory personnel, or highly compensated employees.

5. Another new provision designed to give assurance that these stock purchase plans are nondiscriminatory requires that all employees granted options have the same rights and privileges except that the amount of stock which may be purchased by any employee may be a uniform percentage of total compensation or regular or basic compensation and the plan may provide a maximum number or value of shares to be purchased.

6. Under the plan, the option price may not be less than 85 percent of the market value of the stock at the time the option is granted or not less than 85 percent of the market value of the stock at the time the option is exercised, whichever is the lesser. This restriction is similar to the limitations of present law although slightly more restrictive in some cases.

7. The period over which the option may be exercised cannot exceed 5 years where the option price is not less than 85 percent of the value of the stock at the time of the exercise or 27 months from the date of the grant of the option if the option price is at least in part determined on the basis of the price of the stock at the time the option is granted. Present law provides a 10-year period over which restricted stock options may be exercised but in practice it is understood that options issued under purchase plans generally have a much shorter period over which they may be exercised.

8. A new ceiling is provided to the effect that an employee may not purchase stock at an annual rate in excess of $25,000 a year. This restriction is provided since these plans are designed primarily for broad employee participation.

9. As under present law and in the case of the qualified stock options, the option must not be transferable by the individual other than at death and must be exercisable during the employee's life only by him.

(*c*)(*v*) *Reporting requirements.*—The bill provides that corporate employers are to report on the transfer of stock to an employee in the case of the newly established category of qualified stock options or

present law restricted stock options. They also are to report on the sale of stock by the employee where stock is acquired under a stock purchase plan at a price less than the full value of the stock and where, under a restricted stock option, stock is purchased at a price between 85 and 95 percent of the value of the stock. In these latter two cases, the report of the sale of the stock by the employee is required since generally in these cases ordinary income tax will be payable by him. A copy of the form of the report going to the Government also is to be sent to the employee or former employee on or before January 31 after the year involved. In those cases where the employer is required to report on the sale of stock by the employee, he will not be expected to follow the ownership of the stock beyond the first transfer; e.g., if an employee transfers stock to a street name and then subsequently sells the stock, the employer will report the first transfer of the stock to the street name but will not be required to report the subsequent sale. Moreover, the reporting in these cases is merely to indicate the name, address, and account number of the individual employee involved and the stock sold by him.

(c)(*vi*) *Effective date.*—In the case of qualified options generally the new provisions are to apply to those options granted to an individual after June 11, 1963. However, the new provisions will not apply to an option granted pursuant to a binding written contract entered into before June 12, 1963. Of course, in a transaction which qualified as a tax-free reorganization, where a corporation entered into a binding obligation to assume outstanding restricted stock options previously granted by a corporation, any option which the acquiring corporation issues in assuming the outstanding options already granted by the acquired corporation, to the extent provided by present law, are considered as continuations of the old options and therefore will be considered as granted prior to June 12, 1963, and treated as restricted stock options rather than qualified stock options.

In the case of employee stock purchase plans, also the new provisions apply generally to options granted after June 11, 1963. However, existing law rather than the new law will continue to apply to stock options granted pursuant to a written plan adopted and approved before June 12, 1963, which as of that time met the nondiscrimination requirements specified in the case of employee stock purchase plan. In addition, a plan which was being administered in a way which did not discriminate in favor of officers, supervisory personnel, or highly compensated employees would continue to qualify if adopted and approved before June 12, 1963. Thus, a plan (not otherwise being discriminatory) would be considered nondiscriminatory even though only full-time employees were covered (rather than those working 20 hours a week or more) or those with less than 6 months a year employment were omitted (rather than those with less than 5 months employment).

(*d*) *Revenue effect.*—The changes made by this provision are not expected to have any appreciable revenue effect. To the extent that the changes made above result in a reduction in stock options issued, this will increase deductions taken by corporations as they make deductible payments to employees in other forms.

17. Interest on certain deferred payments (sec. 215(a) of the bill and sec. 483 of the code)

(*a*) *Present law.*—Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. In such cases the full difference between the cost or other basis for the property and the sales price usually is treated as capital gain to the seller. The buyer takes as a basis for the property the total sales price paid. For example, an individual taxpayer might sell a capital asset worth $1,000 for $1,300 payable over 10 years. In this case, if no mention is made that part of this payment is to be treated as interest, and the seller elects to report any gain on the installment basis, then each payment might be treated partly as a return of capital and partly as a capital gain. Over the 10-year period, the taxpayer would report $300 of capital gain (assuming he had the full fair market value of $1,000 as his basis for the property). However, had $300 of this $1,300 payment been specified as an interest payment, this amount would have been ordinary income to the seller rather than capital gain. From the buyer's standpoint, the $300, if treated as part of the price of the property would be added to the basis of the property and, in the case of depreciable property be recoverable over the life of the property. He might also, if the property qualified, be eligible for an investment credit with respect to this $300. On the other hand, if this $300 were treated as interest, he could receive an interest deduction for this amount.

(*b*) *General reasons for provision.*—Your committee sees no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a nondepreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint. Your committee believes that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed.

(*c*) *General explanation of provision.*—Your committee's bill solves the problem referred to above by providing that where property is sold on an installment basis and part or all of the payments are due more than 1 year after the date of the sale or exchange—if no interest payments are specified or if "too low" interest payments are specified then part of each payment due after 6 months is to be treated as interest rather than as part of the sales price.

The interest rate to be used for purposes of this provision is to be a rate provided by regulations prescribed by the Secretary of the Treasury or his delegate. It is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person, in reasonably sound financial circumstances and with adequate security could be expected to borrow money from a bank. A rate

of 5 percent, for example, would appear appropriate under existing circumstances.

With this interest rate specified by the Secretary, the proportion of each payment which would be considered an interest payment would be determined in the following manner: First, the present value of each installment payment would be determined, based upon the specified interest rate. Second, the deduction of the total of these present values from the total actual payments provided for under the contract then would give the total "unstated" interest payments under the contract.[1] Third, the total unstated interest then is assumed to be spread pro rata over the total payments involved. Thus, if a specific payment represents one-tenth of the total payments, it would be assumed to include one-tenth of the total unstated interest.

For ease of administration and compliance, the regulations are to provide for the discounting of payments on a 6-month basis and are to ignore for this purpose any interest payments due within the first 6 months.

Where an installment contract provides for the payment of some interest, no unstated interest is to be computed unless the interest payments specified are at a rate more than 1 percent below the rate of interest payments which would be computed under this provision in the absence of those payments. Thus, if a 5-percent rate is specified by the Secretary, no unstated interest will be computed where the interest actually provided for under the contract is 4 percent or more. This represents a de minimis rule to prevent the application of this provision in those cases where interest variations are relatively minor.

For purposes of this provision, a payment for property in the form of a note, or other evidence of indebtedness of the purchaser, is not to be treated as a payment. To treat such amounts as payments would permit avoidance of this provision merely by exchanging non-interest-bearing forms of indebtedness for property. However, payments made on such indebtedness for purposes of this provision will be treated as if they were payments made on the contract itself.

Where, at the time of the sale or exchange, some or all of the payments are indefinite as to their size; for example where the payments are in part at least dependent upon future income derived from the property, the "unstated" interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is received, taking into account the time interval between the sale or exchange and the receipt of the payment. Also, where there is a change in the amount due under a contract, the "unstated" interest is to be recomputed at the time of each such change.

The bill specifies five situations in which this provision is not to apply: First, a de minimis rule as to price is provided. Thus, the provision will not apply unless the sale price of the property is in excess of $3,000. Second, in the case of the purchaser of the property, if any of the amounts involved are carrying charges which under present law from the standpoint of the purchaser are treated as interest, then, in the case of the purchaser, this provision is not to apply. Third,

[1] Where an interest rate was provided on the installments but at "too low" a rate, the present value o these interest payments would be determined along with the present value of the remainder of the payments as well. The unstated interest then would represent the present values, including the present values of such interest payments, deducted from total payments to be received under the contract excluding the interest payments.

in the case of the seller, this provision is to apply only if some part of the gain from the sale or exchange of the property would be considered as gain from a capital asset or as gain from depreciable property. If the property is sold at a loss, this provision will nevertheless apply if, had there been a gain, some part of it would have been considered as gain from a capital asset or from depreciable property. Fourth, this provision is not to apply in the case of payments with respect to patents, which are treated as capital gain under present law. Fifth, the provision is not to apply where the property is exchanged for annuity payments which depend in whole or in part on the life expectancy of one or more individuals. In addition, this provision, of course, will not apply to payments such as those for timber, coal and iron ore (sec. 631) where the property is treated as sold as the timber is cut or the coal or iron ore is withdrawn, with the result that this is not treated as an installment contract.

(c)(i) *Effective date.*—This provision applies to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963.

(d) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

18. Carrying charges (sec. 215(c) of the bill and sec. 163(b) of the code)

(a) *Present law.*—Among the itemized deductions allowed taxpayers under present law is the deduction for interest payments. Administrative practice has long allowed as an interest deduction the portion of any carrying charges on installment purchases to the extent the interest element is stated separately. In 1954, Congress also provided that an interest deduction was to be available in the case of carrying charges stated separately even where the interest charged could not be ascertained directly. In such cases, the law provides that so much of the carrying charges as equal a 6-percent interest charge on the average unpaid balance under the contract is to be allowable as an interest deduction. This provision applies, however, only in the case of "personal property" purchased under an installment contract.

(b) *General reasons for provision.*—Your committee's attention has been called to the fact that not only is personal property sold under a contract where carrying charges are provided and where the interest element is not separately stated, but also in some cases services are sold in such a manner. One example of such service charges is tuition payments to various educational institutions. Your committee sees no reason why interest deductions should not be equally allowable in such cases as in the case of the sale of personal property.

(c) *General explanation of provision.*—Your committee's bill amends the provision of present law relating to the deduction of interest payments to treat services in the same manner as personal property. Thus, if services, like personal property, are purchased under a contract which provides for part or all of the purchase price to be paid in installments and where there are carrying charges which are stated separately but with respect to which the interest element cannot be ascertained, then a portion of the carrying charges are to be treated as if they were interest payments for purposes of this deduction. As under present law, the interest element in this case is to be 6 percent of the average unpaid balance under the contract during the taxable

year. This, as under present law, is computed on the basis of the sum of the unpaid balances outstanding on the first day of each month during the year.

(*c*)(*i*) *Effective date.*—This provision is to apply to payments made in taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue.

19. Personal holding companies (sec. 216 of the bill and secs. 541–543 of the code)

(*a*) *Present law.*—Under present law, a domestic personal holding company is taxed on its "undistributed personal holding company income" at a rate of 75 percent on the first $2,000 and 85 percent on the balance. This is in addition to the regular corporate income tax. In general terms, a personal holding company is a closely held corporation, most of whose income is derived from certain specified forms of passive income. The tax applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals. In addition, at least 80 percent of the corporation's gross income must be from what is defined as "personal holding company income."

In general terms, personal holding company income consists of income from what are considered to be passive forms of investment. Thus, it includes dividends, interest, and annuities. It also includes most royalties although mineral, oil, or gas royalties are included only where these royalties do not represent more than 50 percent of the company's gross income or where there are not trade or business deductions (other than compensation for personal services rendered by shareholders) equal to 15 percent or more of the company's gross income. Copyright royalties also are classified as personal holding company income if they represent less than 50 percent of the company's gross income or the business deductions (other than compensation for personal services rendered by shareholders) represent less than 50 percent of gross income or if other personal holding company income constitutes more than 10 percent of gross income. Thus, where these mineral, oil, gas, or copyright royalties represent the principal business of the company, this type of income is not classified as personal holding company income, if there also is evidence, in the form of sufficient business deductions, that the company is actively engaged in business. Rents also are classified as personal holding company income unless they represent 50 percent or more of the company's gross income. Other forms of income which are classified as personal holding company income includes income from stock, security, and commodity transactions (except in the case of dealers, producers, etc.), income from estates and trusts, income from personal service contracts where 25 percent or more of the stock of the corporation is owned directly or indirectly by the individual performing the services, and income from the right to use property of the corporation where 25 percent or more of the stock of the corporation is owned directly or indirectly by the person eligible to use the property. This latter category of income, however, is treated as personal holding company income only where 10 percent or more of its income (without regard to this latter category or rents) is personal holding company income.

(*b*) *General reasons for provisions.*—Congress first imposed this tax on personal holding companies in 1934 in order to prevent the avoidance of the individual upper bracket surtax rates, by leaving what is essentially investment-type income in a corporate organization, subject to the lower corporate income tax. As indicated by the Administration, ways around the present personal holding company provisions have been found in several arrangements which permit the use of holding companies to avoid the individual income tax with respect to what is essentially investment-type income without the company involved being classified as a "personal holding company."

The principal avoidance devices involve the use of rental income, income from mineral operations, and certain capital gains which are not classified as personal holding company income as means of sheltering other investment income in such a manner that 80 percent or more of the company's gross income does not come within the technical definition of personal holding company income. In view of this, your committee's bill makes a number of modifications in the personal holding company provisions designed primarily to minimize the extent to which these special categories of income can be used to shelter clearly passive income. More detailed reasons for each of the various modifications provided by the bill are set forth in the explanation given below with respect to each of the modifications.

(*c*) *General explanation of provisions.*—Your committee's bill makes a series of modifications in the application of the personal holding company tax in the case of domestic corporations. However, except in the case of a liquidation, no change is made in the case of foreign personal holding companies. Most of the modifications described below are designed to eliminate various means by which holding companies have been avoiding classification as personal holding companies, although other problems are also dealt with.

(*c*)(*i*) *Tax rate of 70 percent.*—In view of the fact that this bill decreases the maximum tax rate applicable to individuals from 91 to 70 percent, your committee concluded that the rates applicable to personal holding companies also should be lowered from the present rates of 75 percent on the first $2,000, and 85 percent on the excess, to what will be the new top individual income tax rate. Moreover, there appears to be no particular purpose for continuing the graduation in the personal holding company tax rate from 75 percent on the first $2,000 to 85 percent on the balance. In view of this, your committee's bill provides that the personal holding company tax is to be 70 percent of the undistributed personal holding company income.

(*c*)(*ii*) *Decrease in 80-percent test.*—As previously indicated, one of the tests under present law provides that a company, to be a personal holding company, must derive 80 percent or more of its gross income from certain specified types of passive income, called personal holding company income. Your committee's bill decreases this 80-percent test to 60 percent. The decrease in this percentage is made because too many holding companies which are essentially holding companies of passive income have avoided the classification as such by holding their "personal holding company income" just slightly below the 80-percent limit. The more realistic 60-percent limit together with other modifications described below will make the avoidance of this classification much more difficult for holding companies generally.

(c)(iii) Adjusted ordinary gross income requirement.—Under present law the 80-percent requirement referred to above is applied to the gross income of the corporation; i.e., if the gross income derived from certain specified passive sources equals 80 percent of the total gross income of the corporation, the corporation is classed as a personal holding company. This has made it possible for corporations to avoid personal holding company classification by seeking out types of income not characterized as passive, or of a personal holding company type, which give rise to a proportionately large amount of gross income even though leaving little, if any, income after the deductions attributable to this income. In this manner, various types of income have been used to shelter investment income and remove the company from the classification of a personal holding company. Rents, where they constitute more than 50 percent of the gross income of the corporation, are an example of a type of income used to shelter passive income, such as dividends. Mineral, oil, and gas income are the other principal examples of income which have been so used.

To overcome this problem, your committee's bill adjusts downward the income from certain sources to the extent of certain specified deductions attributable to these types of income. Thus, the corporation will be a personal holding company if 60 percent of "adjusted" gross income consists of certain passive income. The adjustments are as follows:

1. In the case of gross income from rents, the deductions for depreciation and amortization, property taxes, interest, and rents paid, to the extent attributable to the rental income received, are to be deducted from gross income.
2. In the case of mineral, oil, and gas royalties and also in the case of working interests in oil or gas wells, the deductions attributable to these royalties or working interests for depreciation, amortization and depletion, property and severance taxes, interest and rents paid are to be deducted in computing this adjusted gross income. It should be clearly understood that although income from working interests in an oil and gas well for purposes of the 60 percent limitation are reduced by the deductions referred to above such income is itself never classified as personal holding company income.
3. Interest from U.S. Government bonds held for sale by a dealer who is making a primary market for these obligations and interest on condemnation awards, judgments and tax refunds also are to be excluded in arriving at adjusted gross income for this purpose. This adjustment serves a different purpose from the first two deductions in that it merely excludes from the base on which personal holding company income is computed this particular type of interest income which in reality is not passive in nature.

In applying the 60 percent test, not only is the total gross income adjusted downward by the amount of the deductions (or interest) referred to in the cases specified above, but also in determining the rental income and mineral, oil, and gas income for purposes of this test, this income also is reduced by the specified reductions.

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(*c*)(*iv*) *Capital gains.*—Under present law capital gains (other than capital gains attributable to stock, securities, or commodities) are not treated as personal holding company income. All capital gains, however, are included in the gross income of the company for purposes of the 80 percent test. As in the case of the deductions referred to above, some companies have timed the realization of their capital gains income in such a manner as to keep their personal holding company income below the 80 percent. Your committee's bill avoids this problem by excluding all capital gains from the gross income in determining whether the 60 percent test is met. Thus, the test under your committee's bill is based on adjusted ordinary gross income.

(*c*)(*v*) *Rental income.*—Under present law rental income is classified as personal holding company income only if it represents less than 50 percent of total gross income. This is based on the concept that where rental income represents the major activity, the activity involved is more likely to be of an active rather than passive character. The bill retains this 50-percent test (applying it, however, to adjusted income from rents and to adjusted ordinary gross income) but adds a second test providing that rental income may be characterized as passive, or personal holding company income even where it represents 50 percent or more of the adjusted ordinary gross income if, apart from the rental income, more than 10 percent of the ordinary gross income (gross income excluding capital gains) of the company is personal holding company income. For this purpose, income derived from the use of corporate property by shareholders is not viewed as personal holding income, but income from copyright royalties and the adjusted income from mineral, oil, and gas royalties is included for this purpose as personal holding company income.

The fact that rental income, both in applying the 60 percent test and also in applying the 50-percent provision to the rental income itself, is determined on the basis of reducing rental income by depreciation, amortization, property taxes, interest, and rents paid has already been noted above.

(*c*)(*vi*) *Mineral, oil, and gas royalties.*—Under present law mineral, oil, and gas royalties are considered to be personal holding company income unless they represent 50 percent or more of the gross income of the company and unless the trade or business expense deductions (other than compensation for personal services rendered by shareholders) represent 15 percent or more of the gross income of the company. Thus, under present law, as in the case of rental income, mineral, oil, or gas royalties are treated as personal holding company income unless they represent the bulk of the company's income. However, in this case there also must be business expenses—indicating the active character of the business—constituting 15 percent or more of the gross income.

The bill retains these two tests but applies them on the basis of the adjusted ordinary gross income, thereby reducing, for this purpose, the income considered to be in these categories by depreciation, depletion, property and severance taxes, interest, and rent paid.

In addition, your committee's bill adds another test which must be met in such cases for the mineral, oil, or gas royalty income to escape characterization as personal holding company income. The personal holding company income of the company, apart from this category of income (but including as such income that from copyright

royalties and from rents), must not represent more than 10 percent of the ordinary gross income of the company. Thus, the personal holding company type income which mineral, oil, or gas royalty income may shelter even where this income represents the bulk of the income of the company must be relatively small; namely, less than 10 percent of ordinary gross income.

(c)(*vii*) *Copyright royalties.*—Under present law, copyright royalties also are considered to be personal holding company income unless they represent 50 percent or more of the total gross income. An additional test which must be met in order to escape such classification is that the personal holding company income, apart from the copyright royalty income, must not exceed 10 percent of the company's gross income and the trade or business expense deductions (other than those for compensation for personal services rendered by shareholders or for royalties paid to shareholders) must represent 50 percent or more of the company's gross income. This provision is modified by your committee's bill in that the requirement that deductions equal at least 50 percent of gross income is changed to provide that they must equal 25 percent of ordinary gross income reduced by royalties paid and by depreciation deductions with respect to the copyrights.

(c)(*viii*) *Produced film rents.*—Under present law payments received from the distribution and exhibition of motion picture films are treated as rentals. As a result, under present law, a corporation may be formed by an individual who owns a motion picture negative and have its earnings treated as rents for purposes of the personal holding company tax. Since in such a case more than 50 percent of its gross income would be considered to be from rents, there would be no personal holding company tax payable in this case.

To meet this problem, the bill provides that payments received from the use of, or the right to use, films generally will be characterized as copyright royalty income. Thus, such income will be classified as personal holding company income unless 50 percent or more of the company's ordinary income is from this source, not more than 10 percent of the company's ordinary gross income is personal holding company income, and the deductions properly allocable to this film income represent 25 percent or more of the gross income from this source reduced by royalties paid and depreciation taken.

The bill, however, retains what is essentially the treatment of present law for "produced film rents." Produced film rents are rents arising from an interest in a film acquired before the production of the film was substantially complete. It was thought that less severe tests should be applied in such cases because the participation in the production of the film in itself indicates an active business enterprise in this case. For produced film rent to escape characterization as personal holding company income, as under present law, these rents need constitute only 50 percent or more of the ordinary gross income of the company.

(c)(*ix*) *Other types of income characterized as personal holding company income.*—Compensation for the use of property by a shareholder, amounts received under a personal service contract, and income from estates and trusts continue to be classified as personal holding company income essentially to the same extent as under present law, except for the fact that capital gain income is not classified as part of gross income in applying the 10-percent test in the case of the use of corporate property by shareholders.

(c)(x) *Personal finance companies.*—Present law provides that certain types of companies are not to be classified as personal holding companies. These include, for example, banks, life insurance companies, and surety companies. Also excluded from such classification are certain types of personal finance companies. Under present law, there are four different types of personal finance companies which are excluded from the personal holding company category. These categories in general terms are as follows:

1. Licensed personal finance companies, 80 percent of whose gross income is interest from loans if at least 60 percent of their gross income is received from loans classified as "small loans" by State law (or $500 if there is no State law limit) and if the interest is not payable in advance and computed only on unpaid balances. In addition, loans to a person who is a 10-percent shareholder must not exceed $5,000 in principal amount. These frequently are known as "Russell Sage" type personal finance companies.
2. Other lending companies engaged in the small loan or consumer finance business, 80 percent of whose gross income consists of interest or similar charges on loans to individuals and income from 80-percent-owned subsidiaries which in turn themselves meet this test. In addition, at least 60 percent of the company's income must be from interest or similar charges made in accordance with small loan or consumer finance laws to individuals where the loans do not exceed the State specification for small loans (or if there is no such limit, $1,500) and if the trade or business expenses of the company represent 15 percent or more of the company's gross income. These companies also must not have loans outstanding to shareholders, with a 10-percent interest or more, which exceed $5,000.
3. A loan or investment company (such as a Morris Plan bank), a substantial part of whose business consists of receiving funds not subject to check and evidenced by certificates of indebtedness or investment, and making loans and discounts. Here also loans to a person who is a 10-percent shareholder may not exceed $5,000 in principal amount.
4. A finance company actively engaged in purchasing or discounting accounts or notes receivable, or installment obligations, or in making loans secured by any of these or by tangible personal property, if at least 80 percent of its gross income is derived from such business. In addition, at least 60 percent of such a company's gross income must be derived from certain categories of income. These categories, in general, relate to business or factoring-type loans: such as purchasing or discounting accounts or notes receivable, or installment obligations arising out of the sale of goods or services by the borrower in his business; making loans for not more than 36 months to businesses where the amounts are secured by accounts or notes receivable or installment obligations of the type described above, or secured by warehouse receipts, bills of lading, inventories, chattel mortgages on property used in the borrower's trade or business, etc. In the case of these companies, the trade or business expense deductions must represent at least 15 percent of the gross income of the company, and loans to those who are 10-percent shareholders in such company must not exceed $5,000 in principal amount.

In the interest of simplification, your committee concluded that it would be desirable to have one exclusion available for all four of these categories of lending or finance companies. At the same time, it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make. This is properly a matter of regulation by State law governing these lending or finance businesses. Moreover, it was recognized that in any event the personal holding provisions do not apply to widely held corporations. In such cases only State law governs the type of loans which can be made.

In view of these considerations, your committee has substituted for all four of the categories described above, one definition of a lending or finance company which is to be excluded from personal holding company tax treatment. This definition is designed first to assure that 60 percent of the company's income is from the active, regular conduct of a lending or finance business, and second that its personal holding company income [1] plus interest from U.S. obligations as a dealer in these obligations is not more than 20 percent of the company's ordinary income. These two limitations, and the restriction described below relating to business expense deductions, give assurance that the company is actively engaged in the lending or finance business and that not more than 20 percent of its remaining income is personal holding company income.

In addition to these two restrictions, the company must have certain business deductions described below, which are directly attributable to its lending or finance business equal to 15 percent of the ordinary gross income up to $500,000 plus 5 percent of the ordinary gross income between $500,000 and $1 million. This provision gives further assurance, as evidenced by the deductions of the company, that it is actively engaged in the lending or finance business. A fourth limitation applicable under present law in the case of all of the categories of lending companies denies the right to make loans to persons who are 10 percent shareholders to the extent of more than $5,000 a year in principal amounts.

The lending or finance business for purposes of this provision is defined as including the business of making loans and purchasing or discounting accounts receivable, notes, or installment obligations receivable, notes or installment obligations. It does not include, however, the making of loans or purchasing or discounting accounts receivable, notes or installment obligations if the remaining period to maturity on the loan or paper exceeds 60 months. It also does not include the making of loans evidenced by indebtedness issued in a series under a trust indenture and in registered form or with interest coupons attached.

Business deductions for purposes of the 15-percent or 5-percent test include only those trade or business expense deductions which are deductible only by reason of section 162 or section 404 (other than compensation for personal services rendered by shareholders or members of their family), and depreciation deductions and deductions for real property taxes to the extent that the property to which they relate is used in the regular conduct of the lending or finance business.

[1] For this purpose personal holding company income is computed without regard to income from subsidiaries qualifying under this exemption as lending businesses, but including gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders.

Trade or business expense deductions which are allowable specifically under other sections, such as the deduction for interest expense which is also allowable under section 163, are not included for purposes of the 15-percent or 5-percent test.

(*c*)(*xi*) *Liquidating dividends.*—Under present law, the 75-percent or 85-percent tax (70 percent under the bill) on personal holding companies applies only to the undistributed personal holding company income. Thus, this tax is applied after dividend distributions are taken into account. Included among the amounts treated as dividends eligible for the dividends paid deduction are distributions in liquidation to the extent of the accumulated earnings and profits. As a result, in the year of the liquidation of a personal holding company there is no income subject to personal holding company tax for that year. Despite the fact that the distributions are treated as dividends to the personal holding company, its stockholders in that year receive this income and report it at capital gains rates.

Thus, under present law, a company which is a personal holding company may nevertheless avoid both the personal holding company tax and the ordinary income treatment to its shareholders with respect to the personal holding company income the year in which it liquidates.

A problem is also presented in the case of corporations where a subsidiary is liquidated and both the parent and the subsidiary corporation are personal holding companies. In such a case, if the earnings and profits of the subsidiary exceed its undistributed personal holding company income in the year of the liquidating distribution, the parent corporation may use the excess dividend paid deduction in computing its own dividend paid deduction, thereby reducing its own undistributed personal holding company income in the taxable year and also in the 2 succeeding taxable years.

The bill meets these problems by limiting the application of section 562(b) to companies other than personal holding companies or foreign personal holding companies. However, it is provided in section 316(b) that in the case of a complete liquidation of a personal holding company within a 24-month period after the adoption of the plan of liquidation, that the term "dividend" is to include any amounts distributed in this liquidation to other than corporate shareholders to the extent of its undistributed income (before any deduction for this amount) only if the corporation involved designates amounts as dividends (and so notifies the distributee). If the corporation does so designate the distributions as dividends the individuals receiving a liquidating distribution from the personal holding company must report the amount so distributed as a dividend in the year of receipt.

An amendment is also made to the code which provides in the case of corporate distributees that where a complete liquidation of a personal holding company occurs within 24 months after the adoption of the plan of liquidation, the distribution is to be treated as a dividend for purposes of the personal holding company tax only to the extent of the corporate distributee's share of the undistributed personal holding company income for the taxable year of the distribution. Thus, the dividends paid deduction is allowed to a personal holding company only to the extent of the undistributed income for the taxable year and with respect to noncorporate distributees, only if such distributees treat such distribution as a dividend.

(c)(xii) *One-month liquidations.*—While your committee believes that the tightening of the personal holding company provisions as indicated in the prior discussion is desirable, nevertheless, it believes that it would be unfortunate to apply these provisions without any alternatives being available, to companies which in the past have not been classified as personal holding companies but which as a result of the new provision will for the first time find themselves subject to personal holding company tax. Your committee believes that it would be unfair to require such companies to pay personal holding company tax if they are willing to liquidate. Although it is understood that some of these companies are willing to liquidate, nevertheless, it would represent a hardship under existing law for them to do so. The hardship arises from the fact that if they liquidate under the provisions of section 331 of the code, not only would the earnings and profits of such corporations be taxed to the shareholders at capital gains rates but also any other appreciation which has occurred in the value of the assets would be so taxed to them. Such companies in the absence of the new personal holding company provisions would face no necessity of liquidating and therefore under these circumstances no tax would now be paid with respect to these unrealized increases in value. Your committee believed it was appropriate therefore to forego the tax at this time on unrealized appreciations in value but to collect the capital gains tax on the earnings and profits distributed.

Your committee's bill, to facilitate the liquidation of these companies, provides a special provision (in sec. 333) applicable in the case of companies which, for one of the two most recent taxable years before the enactment of the new personal holding company provisions were not personal holding companies under existing law, but would have been in that year if the new law provided by this bill had been in effect at that time. In such cases, the bill provides that any distribution made by the corporation to the extent of the earnings and profits accumulated prior to the time of the liquidation is to be taxed at capital gains rates and that any remaining gain is to be recognized only to the extent of assets which consist of money or of stock or securities acquired by the corporation after December 31, 1962. The capital gain referred to above in the case of the earnings and profits is to be a class B capital gain, i.e., it will be eligible only for the 50-percent (and not the 40-percent) exclusion factor and will be subject to the alternate rate of 25 percent (not 21 percent).

To be eligible for the treatment described above, the liquidation of one of these corporations must occur before January 1, 1966. The treatment described above providing capital gains treatment with respect to earnings and profits is not to apply with respect to any earnings and profits to which the corporation involved succeeds after August 1, 1963, as a result of any corporate reorganization or as a result of a liquidation of a subsidiary of that corporation (except earnings and profits which on August 1, 1963, constituted the earnings and profits of one of the companies described above or which were earned by such a company).

In addition to liquidations occurring before January 1, 1966, the class B capital gains treatment for earnings and profits accumulated before 1966 and nonrecognition of gain with respect to any other gains to the extent with respect to assets acquired before 1963 (and assets other than stock and securities acquired thereafter) under your

committee's bill is also to apply to certain corporations which liquidate after 1965. To qualify for this post-1965 liquidation treatment, as in the prior case the corporation involved must be one which in at least one of the two most recent taxable years ending before the date of enactment of this provision was not a personal holding company under present law but would have been had the provisions of this bill been in effect with respect to that year. To qualify for this special post-1965 liquidation treatment, the corporation involved must also have incurred indebtedness in the period from December 31, 1933, to August 1, 1963, which is still outstanding, or incurred indebtedness after August 1, 1963, which merely replaced indebtedness incurred before that time.

Cases have been called to the attention of your committee where corporations have entered into commitments to use their incomes to pay off such debts and where as a result it is difficult, if not impossible, for them to liquidate before this indebtedness is paid off. For that reason, your committee's bill makes the liquidation treatment described above (but only with respect to earnings and profits accumulated before 1966) apply if the corporation liquidates in the year in which it either does pay off the pre-August 1963 indebtedness or could have, if it had devoted all of its earnings or profits after 1963 to this purpose. In addition, it must also devote to this purpose any deductions for depreciation or amortization, since the funds in this case remain in the corporation and can be used to retire indebtedness. Thus, the special liquidation treatment described here with respect to liquidations occurring after 1965 is available only during the period of time necessary for the corporation to retire outstanding indebtedness out of earnings and profits and depreciation allowances.

(c)(*xiii*) *Postponement of new personal holding company provisions for certain corporations.*—To encourage the liquidation of companies which are not now personal holding companies but would become so as a result of the new provisions, your committee has added a provision to the effect that such companies, if they liquidate before January 1, 1966, will not be subjected to the new personal holding company provisions provided by this bill. They will, however, have available to them the special liquidation provisions described immediately above and will be subject to the rules specified in the prior heading with respect to the dividends paid deduction. In addition, this provision will not apply in the case of the liquidation of a subsidiary corporation under section 332 unless before the 91st day after the last distribution of the subsidiary the parent corporation also is liquidated and both of these events occur before January 1, 1966.

(c)(*xiv*) *Deduction for amortization of indebtedness.*—In 1934, when the personal holding company provision was first adopted, Congress provided that indebtedness incurred before 1934 by a company which subsequently became a personal holding company would receive a special debt amortization deduction in computing its personal holding company tax. It was provided that to the extent that this debt was paid off, or amounts were set aside to pay off this debt, the tax base for purposes of the personal holding company tax was to be reduced by the amount of the amortization payments. Thus, these amortization payments were treated for purposes of the personal holding tax as deductions in the same manner as dividend distributions to shareholders.

Your committee's bill adds a similar provision for indebtedness incurred after December 31, 1933, and before August 1, 1963, in the case of corporations which were not personal holding companies in one of the 2 taxable years before the enactment of this provision but would have been had the new personal holding company provision been in effect at that time.

Qualified indebtedness for purposes of this provision includes not only the debt outstanding before August 1, 1963, but also debt which has replaced that outstanding before August 1, 1963 (if the special amortization deduction has not already been taken for the repayment of the old debt). Thus, short-term bank loans, for example, which are renewed at intervals will not be disqualified for purposes of this amortization deduction if the taxpayer elects not to deduct the payment of the prior loan. In addition to deductions for actual payments, deductions are also permitted for amounts (if reasonable) which are irrevocably set aside to pay off a debt which may be payable at some future date.

The deduction for indebtedness under this provision is to be reduced by any deduction which the company receives for depreciation or amortization and for any deduction (in computing undistributed personal holding company income) for net long-term capital gains. These deductions are disallowed since the funds represented by them can be used by the corporation to pay off indebtedness in the same manner as the earnings and profits of the corporation. Any of these deductions not used in 1 year are carried forward for this purpose and used in a subsequent year. A special provision provides that where depreciable property which would give rise to this cutback in the indebtedness provision is disposed of after July 31, 1963, then to the extent the basis of the property disposed of exceeds the indebtedness which was transferred at the time of the same disposition the qualified indebtedness for which a deduction may subsequently be taken is reduced.

(*c*)(*xv*) *Effective dates.*—Generally the personal holding company provisions are made effective with respect to taxable years beginning after December 31, 1963. The dividends paid deduction modification and the liquidation provision, however, are to apply to distributions made in taxable years of the distributing corporation beginning after December 31, 1963.

(*d*) *Revenue effect.*—It is estimated that the personal holding company provision, will result in a revenue increase of $15 million a year in a full year of operation.

20. Increase in basis with respect to certain foreign personal holding company holdings (sec. 216(j) of the bill and sec. 1022 of the code)

(*a*) *Present law.*—Under present law the undistributed income of a foreign personal holding company is included in the income of the U.S. shareholders of the company and taxed to them. This treatment applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals who are citizens or residents of the United States. In addition, in the first year, 60 percent, and in subsequent years 50 percent, of the corporation's gross income must be "foreign personal holding company income." In general terms, this income consists of passive or investment forms of income, such as dividends, interest, etc.

To a substantial degree, the same type of income is classified as foreign personal holding company income as is classified as personal holding company income in the case of domestic companies.

Stock in a foreign personal holding company differs from most other property in that, at the time of the death of the U.S. shareholder, it generally does not receive a new basis equal to its fair market value. Actually, the applicable rule in this case is that the basis of the stock at the time of the death of the decedent is to be the fair market value at that time or the basis of the stock in the hands of the decedent, whichever is *lower*.

For foreign corporations, including foreign personal holding companies, to participate in a tax-free reorganization it must be determined to the satisfaction of the Secretary of the Treasury that the exchange was not in the pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Of the two basic tax provisions on corporate liquidations, sections 331 and 333, foreign companies can use only section 331. Section 331 provides for the imposition of the regular capital gains tax on appreciation in the value of the stock. Section 333, which foreign corporations cannot use, provides that the accumulated earnings and profits of the corporation are to be taxed to the noncorporate shareholders as dividends and that capital gains are to be recognized on other appreciation in the stock only to the extent of the money and stock or securities acquired by the corporation after December 31, 1953, exceed the earnings and profits received as dividends. However, this provision also provides, in the case of assets acquired by the corporation before January 1, 1954, that no gain is to be recognized to the shareholder but that instead the shareholder is to receive the same basis for the assets received which he had for the stock (increased for gain recognized and decreased for money received.)

(*b*) *General reasons for provision.*—As indicated above, stock of foreign personal holding companies, when the shareholder dies, receives much harsher tax treatment than is true of practically all other property included in the decedent's estate. Generally, property receives a new basis at a decedent's death equal to the fair market value of the property, either at the time of the decedent's death or at the alternate valuation date 1 year later. Even in the case of gifts, where the donee carries over the basis of the donor, an increase in the basis (up to fair market value) is allowed to the donee with respect to any gift taxes paid on the property.

Your committee recognizes that it is the policy of the United States to discourage the formation of foreign personal holding companies and, in fact, to generally encourage their liquidation. The formation and use of these companies is discouraged by the fact that their earnings are taxed to the shareholders in the year in which they are earned, whether or not distributed. Your committee also recognizes that a relatively harsh treatment for the basis of the stock of these companies is justified in order to discourage their use generally. However, even though an increase in basis to the fair market value is not allowed, your committee believes that it is at least appropriate to permit the same general type of adjustment which is permitted with respect to gifts; namely, to permit an increase in the basis of the stock of foreign personal holding companies equal to the death transfer tax imposed with respect to the appreciation in the value of this stock.

In addition, as a special means of encouraging the liquidation of these corporations, your committee's bill provides that these foreign personal holding companies are to be treated the same as domestic corporations for purposes of section 333, if the liquidation is completed shortly after the date of enactment of this bill. Since such companies have little, if any, accumulated earnings and profits, this in effect means that they pay a capital gains tax on appreciation of their stock in the corporation only to the extent that they receive money or in stock or securities acquired after December 31, 1953, and that the basis of the assets received in the liquidation is the basis of their stock in the corporation increased by the gain recognized. To be sure that there are no opportunities for tax avoidances in such cases, it is provided, however, that this property is to receive the same basis as it would if the shareholder died still holding the stock in the foreign personal holding company until it (or any property "substituted" for it) has passed through one estate—the shareholder's or any transferee's. As a result, the basis of the stock, generally, is carried over, but increased for estate taxes attributable to the appreciation in value of the assets.

(*c*) *General explanation of provisions.*—This provision deals with two basic subjects. The first of these relates to the basis of stock in a foreign personal holding company at the time of the death of the shareholder. The second provides special rules, for a limited period of time after the enactment of this bill, where the personal holding company is liquidated. This latter subject also deals with the basis of the assets distributed in such a liquidation when the former shareholder subsequently dies.

(*c*)(*i*) *Increase in basis for foreign personal holding company stock.*—As indicated previously, present law provides that the basis of stock or securities of a foreign personal holding company on the death of the shareholder involved is to be the fair market value of such property at the time of the shareholder's death, or the basis in his hands, whichever is lower. This bill adds to the basis of the stock or securities so determined the shareholder's proportionate share of any Federal estate tax payable with respect to his estate, but only to the extent that this Federal estate tax is attributable to the appreciation in the value of the decedent's shares or securities in the foreign personal holding company.

This treatment applies only in those cases where a foreign corporation was a foreign personal holding company in its most recent taxable year before the date of the enactment of this provision. It also applies only in the case of shares of stock or securities held by a decedent dying after August 15, 1963.

The Federal estate tax, with respect to which the upward adjustment in the basis of the stock or securities is made, is the Federal estate tax before any reduction for credit except the credit allowable with respect to a tax on prior transfers at death. Thus, an increase in basis will be allowed for State death taxes to the extent they are creditable against the Federal estate tax. However, only a portion of the Federal estate tax will be added to the basis for the foreign personal holding company stock or security. This will be the amount attributable to the unrealized gain in the hands of the decedent with respect to the stock or security. The tax attributable to this will be determined on the basis of the ratio of the appreciation in value of this stock or securities to the total value of the gross estate of the decedent.

The addition to basis described above, with respect to foreign personal holding companies, will not apply to any foreign corporation which, with respect to any taxable year beginning on or before and ending after August 26, 1937, was a foreign personal holding company.

(c)(ii) *One-month liquidations.*—Your committee's bill provides that where certain conditions are met a foreign personal holding company will be treated as a domestic corporation for purposes of section 333 of the Internal Revenue Code. This has the effect of permitting the liquidation of these corporations—

(1) taxing as a dividend any accumulated earnings and profits of the corporation;

(2) taxing as capital gain, so much of the assets received which consist of money or stock and securities acquired by the corporation after December 31, 1953 (to the extent any gain exceeds the amount taxed as a dividend under (1) above); and

(3) allowing the remaining portion of the appreciation of the shareholder's stock in the corporation to go untaxed at the time of liquidation, but providing a basis for the assets received in the liquidation equal to the basis of such shareholder in his stock of the corporation (decreased for any money received and increased for any gain recognized).

To be eligible for the liquidation treatment described here, three conditions must be met:

(1) The company must have been a foreign personal holding company for its most recent year ending before the date of enactment of this bill;

(2) All of the stock of the corporation must have been owned by individuals and estates, both on August 15, 1963, and at the time of liquidation; and

(3) The transfer of the property to the shareholders under the liquidation must occur within one of the first four calendar months ending after the date of the enactment of this bill.

Although the foreign personal holding companies meeting the terms of this provision are classified as "domestic corporations" for purposes of section 333, nevertheless, they are treated as foreign corporations for purposes of section 367. Section 367 provides that in determining the extent to which gain is to be recognized in the case of certain exchanges (including, for the purpose of this provision, a liquidation under sec. 333), foreign corporations are not to be considered as "corporations," unless before such exchange it has been established to the satisfaction of the Secretary of the Treasury that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Thus, unless this clearance is obtained the liquidation would be treated as an exchange of property with the full amount of any gain subject to tax. However, in applying section 367 to a liquidation of a foreign personal holding company under section 333, it is not the intention of your committee that an opportunity to gain an increase in basis for the property being distributed upon the death of any decedent involved is to be considered an avoidance of Federal income taxes under section 367. The added amendment described immediately below which limits the basis adjustment available in such cases, in the view of your committee, prevents any significant tax escape in this area.

Normally, stock or securities held directly by an individual would, upon his death, receive an increase in basis to reflect the fair market value of these securities at that time (or the optional valuation date). As indicated previously, however, in the case of the stock of a foreign personal holding company, this increase in basis at the date of a shareholder's death is not available. Instead, the basis of the decedent in the stock is carried over but increased, as indicated above, in this bill, by any Federal estate tax attributable to the appreciation in the foreign personal holding company stock. Your committee's bill, in the case of property received in a liquidation under section 333, provides that the property distributed is not to receive the normal increase in basis at the date of the shareholder's death. Instead, this property will retain its basis but, as in the case of the foreign personal holding company stock itself, will be increased by the Federal estate tax attributable to any unrealized appreciation in this property. The method of computing the Federal estate tax here is the same as that described above in the case of the stock in the foreign personal holding company. In addition, where anyone has received such property from the shareholder (or from a person who acquired such property from the shareholder other than by transfer at death) without the full gain being recognized in the transaction, the adjusted carryover basis rule described above applies upon such a person's death. In the case of property acquired from the decedent by gift the increase in basis upon the donee's death is not to exceed the adjustment provided here, or the adjustment provided with respect to gifts, whichever is the greater.

(*c*)(*iii*) *Effective date.*—The amendments made by this provision, relating to the adjustment to the basis of stock in a foreign personal holding company upon the death of a shareholder in such a company, applies to decedents dying after August 15, 1963. The provision permitting a liquidation of a foreign personal holding company applies to liquidations occurring within one of the first 4 calendar months, ending after the date of enactment of this bill.

(*d*) *Revenue effect.*—It is believed that this provision will not result in any appreciable revenue loss.

21. Treatment of property in the case of oil and gas wells (sec. 217 of the bill and sec. 614 of the code)

(*a*) *Present law.*—The percentage depletion deduction, in the case of oil and gas, is either 27½ percent, multiplied by the gross income from the "property" or, if less, 50 percent of the net income from the "property." As a result, what constitutes "property" is of considerable significance in determining the percentage depletion deduction available. To avoid any reduction in the 27½ percent deduction on gross income from the property, it frequently is desirable to combine wells having a high ratio of net income to gross income with those having a low ratio so that the 50 percent net income limitation will have little, or no, effect.

At one time each separate mineral deposit in a lease or fee acquisition was treated as a separate property. Subsequently, the administrative practice arose of permitting, at the taxpayer's option, the aggregation or combination of deposits in a single lease or acquisition (sometimes referred to as a single tract or parcel of land). In 1954, Congress permitted the aggregation of properties across lease lines so long as all

the properties were in one "operating unit." This change was prompted by circumstances of the hard mineral industry but it also applied to the oil and gas industries as well. In 1958, Congress adopted detailed rules in the case of the hard minerals. In general these rules provided that operating mineral interests may be aggregated mine by mine and any number of mines may be aggregated so long as they are in a single operating unit. These rules, to the extent applicable to hard minerals remain in force. In the case of oil and gas, Congress in 1958 gave operators an option to use either the 1939 code "lease" rule or the 1954 code "operating unit" rule.

The law and the regulations in the case of the "operating unit" rule provide that it is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land, or in contiguous tracts or parcels of land, so long as the interests are a part of the same "operating unit." In defining the "operating unit," the regulations refer to operating mineral interests which are operated together for the purpose of producing minerals. With respect to any taxpayer what constitutes an "operating unit" must be determined on the basis of his own operations. The operating units may not be uniform in the various natural resources industries or in any one of the natural resource industries. Moreover, in the case of a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term "operating unit" refers, however, to a producing unit and not an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are—

(1) Common field or operating personnel;
(2) Common supply and maintenance facilities;
(3) Common processing or treatment plants; and
(4) Common storage facilities.

It is made clear that operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests or merely because the products of the interests are processed at the same treatment plant. Generally, however, the determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(*b*) *General reasons for provision.*—There have been two major objections to the operating unit rule adopted in 1954 as applied to oil and gas. First, it has been difficult to determine what an operating unit is and this is a continuous source of controversy between taxpayers and the Government. The problem arises from the fact that the term "operating unit" apparently has no generally understood meaning within the oil and gas industries. Basically, it is a tax concept having no real business substance.

Second, the operating unit rule has proved objectionable because it gives taxpayers an opportunity to increase their percentage depletion deduction merely by choosing the best combination of high and low cost properties for purposes of this aggregation rule. This opportunity, of course, is available only to those large enough to have many diverse property interests. It is possible under this rule to include some leases or tracts of land within a large area and to omit others even

though the latter may be contiguous to some of the property included, while other property included in the aggregation may be many miles away. Taxpayers, in fact, are contending that the term "operating unit" covers operations over widespread geographical areas, including substantial portions of several States.

To remove this controversy and also to delete this opportunity for larger companies to maximize their percentage depletion deductions by unrealistic grouping of properties, your committee's bill for the future eliminates the operating unit aggregation rule in the case of oil and gas properties. No inferences are to be drawn from this, however, as to what constitutes an operating unit or as to what could properly be aggregated with respect to the period of time before this change is made. In place of the operating unit rule taxpayers, as was true before 1954, will be able to maintain separate deposits as separate properties or can combine some or all deposits falling within a single lease or acquisition. They will not, however, be able to combine different leases or acquisitions, except in the case of properties which are in a unitization agreement. In these latter cases the owners of the property have in effect exchanged their separate interests in their leases for undivided interests in the whole, with the result that all interests of a taxpayer in the unit become one property.

(*c*) *General explanation of provision.*—The operating unit rule of existing law provides that if a taxpayer owns two or more separate operating mineral interests which constitute all or a part of an operating unit, he may form one aggregation and treat as one property any two or more of these interests, treating as separate properties any interests which he does not include in this one aggregation. Separate operating mineral interests may be aggregated for this purpose whether or not they are in a single tract or parcel of land, or contiguous tracts or parcels. A taxpayer may not, however, form more than one aggregation within a single operating unit.

Your committee's bill repeals the rule described above for taxable years beginning after December 31, 1963, with respect to oil and gas. It substitutes in its place a rule which, in effect, restores the pre-1954 administrative practice. No longer will the aggregation of properties be permitted at the "operating unit" level. Except in the case of unitization agreements discussed below, taxpayers may not aggregate oil and gas properties above the level of a separate lease or acquisition, or "separate tract or parcel of land" as referred to in the bill.

The general rule which will apply in the future is that all of the taxpayer's operating mineral interests in a separate lease or acquisition will be combined and treated as one property. However, the taxpayer may elect to treat separately operating mineral interests within a single lease or acquisition. Where he does this he may have either no combination, or one combination of mineral interests in that tract or parcel of land. If he has one combination, all other mineral interests not in that combination are treated as separate properties.

Where the taxpayer has elected to treat separately some or all of the operating mineral interests in a single lease or acquisition, and subsequently finds or acquires new interests in that property, the new interests, unless he elects otherwise, are to be treated as a part of the combination, if there is a combination, or as separate properties if there is no such combination.

The election to treat part or all of the operating mineral interests in a lease or acquisition as separate properties must be made at the time of the filing of the return for the first taxable year beginning after December 31, 1963, or if later, the first taxable year in which an expenditure for the development or operation of the operating mineral interest is made by the taxpayer after acquisition.

(c)(i) *Unitization or pooling arrangements.*—As previously indicated a unitization or pooling agreement is to be an exception to the rule stated above. A unitization agreement arises where two or more taxpayers holding interests in separate tracts or parcels of land exchange their interests for an undivided interest in a larger area (either by formal conveyances or contractual arrangement). Such an agreement also arises where a taxpayer holding operating mineral interests in several leases enters into an arrangement to pay the lessors royalties based on an undivided share of the oil and gas from all the leases. The bill provides that in these cases all of the operating mineral interests of a taxpayer which participate in one of these unitization agreements are to be treated as a single property without regard to the rules specified above. This treatment applies to all compulsory unitization agreements required by State law and also to voluntary agreements which meet both of the following two tests:

(1) The operating mineral interests must be in the same deposit or two or more deposits, the joint development or production of which is logical from the standpoint of geology, convenience, economy, or conservation; and

(2) The operating mineral interests covered by the agreement must be in tracts or parcels of land which are either contiguous or in close proximity.

In making this determination under No. (1), tax benefits are not to be taken into account.

A special rule is provided in the case of unitization agreements entered into in taxable years beginning before January 1, 1964. In these cases, where for the last taxable year beginning before 1964 the taxpayer treated each interest as a separate property and if it is determined by law that this was the proper treatment, then the taxpayer may, if he so desires, continue to treat these interests as separate properties despite the fact that they are in a unitization agreement.

(c)(ii) *"Unscrambling" of basis.*—In the past, because of the "operating unit" rule, taxpayers have aggregated two or more separate leases or acquisitions which under the new rules provided by this bill, they must treat separately. This means that any basis for these properties must be segregated or "unscrambled." In the great majority of the cases, it is understood that this will present no problem because of the fact that the entire basis of the property involved has already been written off by percentage depletion deductions. However, for those where some basis still remains, the bill provides two rules, either of which may be followed in "unscrambling" the basis of the operating mineral interests which for the future must be treated as separate properties. The first of these rules provides that any basis may be divided among the separate properties in accordance with the fair market value of each property. The second rule provides that taxpayers may take the adjusted basis of each property at the time it was first included in an aggregation and adjust this basis downward for adjustments reasonably attributable to the property so that the

total of these adjusted bases equals the adjusted basis of the former aggregation.

(c)(iii) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This does not involve any change in elections for those already covered under the 1939 Code rules (sec. 614(d)).

(d) *Revenue effect.*—It is expected that this provision will result in an annual increase of revenue of $40 million.

22. Treatment of iron ore royalties (sec. 218 of the bill and secs. 631(c), 1231(b), and 272 of the code)

(a) *Present law.*—Under present law, iron ore royalties give rise to ordinary income; against this, however, a depletion deduction of 15 percent may be taken.

In the case of coal royalties, however, where the property has been held over 6 months present law provides that the excess of the amount realized from the disposal of the coal, over the adjusted depletion basis and the expenditures attributable to making and administering the contract and in preserving the economic interest retained in the contract, is to be treated as a capital gain. Elsewhere in this bill, this gain is treated as a class B capital gain; i.e., even though the holding period may exceed 2 years, nevertheless, the inclusion factor is to be 50 percent (not 40 percent) and the alternate rate of tax is to be 25 percent (not 21 percent). Where capital gain is realized from coal royalties, no deduction is allowed for percentage depletion or generally for the making and administering of the contract or the preservation of the economic interest in the contract.[1]

(b) *General reasons for provision.*—Your committee believes that the tax treatment now available with respect to coal royalties also should be extended to iron ore royalties as well. The capital gains treatment was made available in the case of coal royalties in part at least to encourage leasing, and therefore production, at a time when the coal industry was facing strong competition from other forms of fuel energy. Today, domestic iron ore production also generally is decreasing. In recent years, for example, iron ore production in the United States has been as follows:

	Thousands of long tons
1950	98, 045
1955	103, 003
1958	67, 709
1959	60, 276
1960	88, 784
1961	71, 329

Source: Department of Interior, Bureau of Mines, Minerals Yearbook.

The capital gains treatment provided by this bill should encourage domestic leasing of iron ore properties to operators, and therefore should improve the position of domestic iron ore production relative to foreign production.

Your committee recognized, however, that iron ore royalties do not represent income from the sale or exchange of capital assets and for that reason has classified income from iron ore royalties as class B

[1] Where the expenditures referred to above plus the adjusted depletion basis of the coal disposed of exceed the amount realized under the contract and are not used to offset other gains, a loss is allowed (if some income is realized under the contract).

capital gains rather than as class A gains even though held more than 2 years.

(c) *General explanation of provision.*—Your committee's bill provides that, as in the case of the disposal of coal, where iron ore is disposed of after being held for more than 6 months by the owner under a contract in which the owner retains an economic interest in the iron ore, the difference between the amount realized from the sale of the iron ore and certain costs is to be treated as a capital gain. The costs taken into account for this purpose are the cost of the property itself (adjusted downward for any depletion deduction taken) plus expenditures in the taxable year for making and administering the contract and the preservation of the economic interest retained under the contract. However, where these expenditures together with the adjusted basis of the property exceed the amount realized under the contract and are not used to offset other gains from the sale or exchange of "property used in the trade or business," a loss is to be recognized. Thus, the costs and expenses incurred by the taxpayer are to decrease the amount received in determining the amount treated as a capital gain.

Your committee's bill treats these iron ore royalties like coal royalties as "property used in the trade or business." As a result, if the gains from iron ore royalties plus the gains from other "property used in the trade or business" exceed the losses from the same type of property, the gain is to be treated as capital gain. Under your committee's bill, this capital gain both in the case of coal royalties and iron ore royalties is to be classified as a class B capital gain. As a result, royalties from such property held more than 6 months will be eligible only for the 50 percent inclusion without regard to whether or not the property has been held for more than 2 years. In addition, the maximum alternative capital gains rate which is to apply in these cases is 25 percent rather than 21 percent.

In obtaining this capital gains treatment for the iron ore royalty the lessor must forgo any depletion deduction with respect to his property (although his adjusted depletion basis is taken into account in computing his gain). In addition, he must generally forgo any deductions for expenditures attributable to the making and administering of the royalty contract and any expenditures attributable to the preservation of his economic interest in this contract. The primary exception to the denial of the deductions in this case is where these expenses plus the adjusted depletion basis for the iron ore disposed of exceed the royalty payments received and are not offset against other gains. With respect to this excess, a loss is allowed.

This capital gains treatment is available only to lessors and sublessors who are not themselves participants in the production of the iron ore either as coadventurers, partners, or principals. The iron ore for this purpose is considered as being sold on the date the iron ore is mined.

(c)(i) *Effective date.*—The capital gains treatment provided by this provision is to apply to iron ore mined in taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—This provision is expected to result in an annual loss of revenue of $5 million.

23. Capital gains and losses (sec. 219 of the bill and secs. 1201, 1202, 1212, 1222, 1231, 1235, 1240, 402 and 403 of the code)

(*a*) *Present law.*—Under present law, capital gains and losses are divided into two general classifications: short-term capital gains and losses and long-term capital gains and losses. The former are gains and losses on assets held for not more than 6 months and the latter are gains or losses on assets held for longer periods of time.

Gains and losses in each category are first offset against other gains or losses in the same category. Thus, there is determined "net" short-term gains or losses and "net" long-term gains or losses. Next, any net short-term gains are offset by net long-term losses or vice versa.

Net short-term gains in excess of net long-term losses are taxed to individuals or to corporations as ordinary income. In the case of net long-term gains in excess of net short-term losses, however, the tax treatment applicable to individuals and corporations differs somewhat. In the case of individuals, such a gain is included in the taxpayer's ordinary income and then reduced by a 50 percent deduction, or alternatively, the entire gain may be omitted from the taxpayer's ordinary income base and a flat 25 percent tax paid with respect to this gain. In the case of corporations, there is no special 50 percent deduction. Instead, the corporation either includes the entire gain in its ordinary income or alternatively pays a tax of 25 percent on these capital gains.

The tax treatment of capital losses also differs somewhat between individuals and corporations. As previously indicated, any net short-term loss is first offset against any net long-term capital gain and vice versa. If there still remains an excess of capital losses (either short term or long term), these losses may be offset against ordinary income in the case of individuals but only to the extent of $1,000. If any net loss still remains, it may be carried forward for a period of up to 5 years as a short-term capital loss (whether such loss was in reality a long- or short-term loss) and as such in each of the years in succession first offset against net short-term capital gains, then against net long-term capital gains and finally against ordinary income to the extent of $1,000.

In the case of corporations, capital losses as in the case of individuals are first offset against gains in their own category (short term or long term) and then against gains in the other category. However, any remaining loss may not be offset against ordinary income to any extent, but, it may be carried forward as a short-term loss and offset against short-term and long-term capital gains in each of the 5 succeeding taxable years.

The capital gain and loss treatment described above applies in the case of the sale or exchange of capital assets. Capital assets generally are defined by the code as any property held by the taxpayer except—

1. Inventory or property held primarily for sale to customers;
2. Depreciable property;
3. Copyrights, literary, artistic compositions, and similar property held by the creator of the property;
4. Accounts or notes receivable acquired in the ordinary course of trade or business or from the sale of services or inventory; or
5. A governmental obligation issued on a discount basis and payable without interest.

In addition, certain other items are taxed in the same manner as capital gains. The principal category of assets treated in this manner are depreciable assets. Such assets, if the gains exceed the losses, are treated as capital gains; but, if the losses are in excess of the gains, they are treated as ordinary losses. Included with depreciable property for this purpose also are gains or losses from—

1. the sale of timber;
2. coal royalties;
3. livestock held by the taxpayer for draft, breeding, or dairy purposes if held by him for 12 months or more;
4. the sale of an unharvested crop sold in connection with the sale of the land.

Other types of items which are eligible for capital gain treatment are patent royalties received by the creator of the patent, certain lump-sum pension payments, and certain termination payments received by employees with more than 20 years employment. Income arising from the sale of stock acquired under a restricted stock option represents still another form of income accorded capital gains treatment under present law. In addition, this bill (sec. 218) provides capital gain treatment for iron ore royalties.

(*b*) *General reasons for provision.*—Your committee's bill makes three basic changes in the tax treatment outlined above: First, it decreases from 50 percent to 40 percent, in the case of individuals, the proportion of the capital gain included in the tax base where the asset involved has been held more than 2 years, and provides in such cases a maximum tax rate of 21 percent in lieu of 25 percent: second, it limits the more favorable capital gain treatment described above so that this treatment will not be available with respect to transactions where the capital gains treatment under present law is made applicable to certain types of assets which are not capital assets; and third, it provides an indefinite carryover of unused losses in the case of individuals in lieu of the present 5-year limitation.

Your committee has decreased the inclusion factor in the case of capital assets held over 2 years in part to correspond with the rate reduction provided for individuals generally. Probably more important, however, has been your committee's desire to "unlock" capital investments where the investor is willing to undertake new and riskier investments needed by the economy but finds it unprofitable because of the substantial tax liability he incurs at the time of the sale of his present holdings. It is estimated that this unlocking effect will stimulate the realization of capital gains to such an extent that in the first year revenues from this source will increase by $450 million even though a smaller percentage of all capital gains is taken into account for tax purposes. This larger turnover of capital assets should result in increased investments and will be particularly helpful in tapping new sources of risk capital.

Similarly, the indefinite extension of the capital loss carryover is intended to increase the volume of funds available for investment in new and risky enterprises. By giving greater assurance that any capital loss incurred from a venture eventually can be offset against income otherwise taxable, the risk in such ventures is decreased, thereby making such investment relatively more attractive.

Although your committee believed it was desirable to provide added inducements for investments generally, it concluded that this

reasoning would not justify the extension of this more favorable tax treatment to situations under existing law where capital gains treatment is accorded to other than capital assets. In many of these cases, the capital gains treatment was provided not because the transactions were essentially capital transactions but rather because hardships existed under the tax treatment which would otherwise be accorded. As a result, the capital gains treatment in many of these cases was provided as a special tax benefit to overcome some undesirable hardship which would otherwise occur. This does not justify extending to such income the more generous treatment accorded capital assets which your committee believes is desirable to stimulate investment generally.

(c) *General explanation of provisions.*—Your committee's bill makes no change in short-term capital gains and losses. Such gains and losses for both individuals and corporations still are from assets held for not more than 6 months. For corporations, long-term assets will remain as those held for more than 6 months, and will continue to be taxed either by including the entire amount in the corporation's ordinary income tax base or by subjecting such gains to a tax of 25 percent.

In the case of individuals and other taxpayers, however, what are presently classified as long-term capital gains and losses are divided into two groups: The first refers to assets held for more than 6 months but not more than 2 years. This category is known as class B capital gains or losses. In the second category are assets held for more than 2 years. Gains and losses as to these are referred to as class A capital gains or losses.[1]

Class B capital gains will continue to be treated in the same manner as long-term capital gains under existing law. That is, any class B capital gain after having been properly offset by any class A or short-term capital losses is includable in income but a deduction may be taken against such income for 50 percent of this gain. Thus, in effect, 50 percent of these gains are being included in income. The alternative rate of tax, which applies to such gains in those cases where it results in a lower tax than the inclusion of 50 percent of the gains in ordinary income remains at the present flat rate of 25 percent.

Class A capital gains are given more favorable treatment then are long-term capital gains under existing law. Such gains, after being properly offset by class B and short-term capital losses, are includable in ordinary income; but, in this case, a deduction of 60 percent of this gain is allowed against ordinary income. Thus, in effect, only 40 percent of the gain is included in ordinary income. The alternative rate of tax which is applicable in the case of these gains, where it results in a lower tax than the inclusion in ordinary income of 40 percent of such gains, is 21 percent.

The alternative tax under your committee's bill is computed by adding the taxes on the adjusted class A and adjusted class B capital gains after having applied the appropriate tax rate in each case. Thus, the alternative tax computation in this case for both types of these gains is made as one computation and not as separate computations for each class of gain.

Your committee's bill provides specifically the order in which capital losses of any particular category are to be applied in reducing

[1] As is noted subsequently certain types of noncapital assets even though held more than 2 years nevertheless are treated as class B capital gains.

other categories of net capital gain. It provides that net class A losses are to be taken into account first and that such losses are first to reduce net class B capital gain and then to the extent of any remaining loss to reduce any net short-term capital gain. Next, net class B losses are to be taken into account and they are to be applied first against net class A gain and then against any net short-term capital gain. Finally, net short-term capital losses are to be taken into account and they are to be applied first against any net class B capital gain and then against any net class A capital gain. This provides an orderly manner for taking into account various types of losses and gives assurance that they will not be applied in a manner which provides any special benefits.

Previously, it was pointed out that under existing law sales or exchange of depreciable property used in a trade or business [2] when resulting in a net loss were treated as resulting in ordinary gains and losses; but when a net gain resulted, capital gain and loss treatment was provided. This treatment is continued by your committee's bill. Where there is a net gain, these assets will be treated in the same manner as capital assets. That is in the case of an individual gains and losses from those held more than 6 months but not more than 2 years will be treated as class B capital gains and losses; and gains and losses from those held for more than 2 years will be treated as class A capital gains and losses.

(*c*) (*i*) *Capital loss carryover.*—As indicated above, in the case of individuals under present law net capital losses for a year are allowed to offset ordinary income in that year to the extent of $1,000. Then, any loss still remaining is treated as a short-term capital loss (without regard to whether it was in reality short term or long term) and carried over, unless earlier exhausted, successively to each of the 5 succeeding years, being applied in each of these years first against short-term capital gains, then against long-term capital gains and finally against ordinary income to the extent of $1,000. In the case of corporations, also, a 5-year capital loss carryover is provided; but, in this case, no offset is provided against ordinary income.

Your committee's bill retains existing law in the case of corporations. In the case of individuals and other taxpayers however, it removes the 5-year limitation. As a result, if capital losses cannot be absorbed in the first 5 years after the taxable year, under your committee's bill they will continue to be available as offsets against income in subsequent years without any time limitation.

Your committee's bill departs from present law in the case of individuals in one other respect. Losses carried forward instead of always being classified as short-term capital losses for this purpose will be classified as short-term, class B, or class A, depending upon their origin; and when carried over to the year in question they will be treated in the same manner as if they were losses of these types incurred in that year and offset in the same manner as such losses. The removal of the 5-year restriction on the loss carry-forward removes the necessity of separately classifying capital losses which have been carried over to a year from those incurred in such year, since there will be no denial of any offset of losses after the expiration of 5 years.

[2] Also included in this category are recognized gains from the involuntary conversions of property used in the trade or business and of capital assets held for more than 6 months.

(c)(ii) *Gains and losses treated only as class B gains and losses.*—In the cases described below, your committee's bill provides that the present tax treatment of the gains or losses will continue to apply even though the property involved is held for more than 2 years. Thus, gains from the sale of these properties will always be classified as class B capital gains if the properties had been held for more than 6 months. The cases where this class B capital gains treatment will apply where the assets have been held more than 6 months are as apply even where the assets have been held more than 2 years are as follows:

1. Timber cut by the taxpayer who owns the timber or has a contract right to cut it (including what are in effect "Christmas trees" if more than 6 years old) and also timber where the disposal occurs under a contract in which the owner retains an economic interest in the timber. The types of timber contracts referred to here are those which were for the first time accorded capital gains treatment in the Revenue Act of 1943. The sale of timber in other contracts which before that time gave rise to capital gains will be eligible for class A treatment where the timber has been held for more than 2 years. This would be true, for example, in the case of timber sold with land and also timber sold outright without any retained economic interest by the seller of the timber.
2. Coal royalties (not otherwise eligible for capital gains treatment).
3. Iron ore royalties, which by section 218 of this bill are given capital gains treatment.
4. Livestock held by the taxpayer for draft, breeding, or dairy purposes if held by him for more than 12 months.
5. An unharvested crop on land used in the trade or business for more than 6 months where the crop and land are sold at the same time to the same person.
6. The sale of all of the substantial rights to a patent or an interest in a patent held for more than 6 months by the individuals whose efforts created the property. This includes payments which are payable over the period of the use of the patent and also those which are contingent on the productivity, use, or disposition of the patent. This does not, however, prevent anyone from receiving class A capital gains treatment for patents held more than 2 years if apart from section 1235 of the code capital gains treatment is already available to them.
7. Certain employee termination payments. The payments referred to here are amounts an individual receives on the assignment or release of all of his rights to receive, after the termination of his employment, for a period of not less than 5 years, a percentage of future profits or receipts of the employer. Also, in order to qualify for this treatment, the employees involved must have been in this employment for more than 20 years. In addition, the rights to receive these payments after employment must have been included in the employment terms of the individual involved for not less than 12 years and must have been in existence before August 16, 1954, and the amount received for the assignment or release of this amount must be received in 1 taxable year.
8. Lump-sum payments received under qualified pension, profit sharing, or stock bonus plans. These payments, to qualify for capital gains treatment under present law, must be payable within 1 taxable

year to the distributee as a result of his death or other separation from employment.

Under present law, where the lump-sum pension, profit sharing, or stock bonus payments are made in the form of a distribution of the employer's stock, the capital gains treatment at the time of the distribution applies only to the contributions of the employer plus any earnings accrued on the employer's (or the employee's) contribution. No capital gain is considered to be realized at the time of the distribution of the employer's stock, however, with respect to the portion of the distribution representing the unrealized appreciation in the value of this stock. Such appreciation became taxable to the individual only subsequently if he should sell the stock.

Your committee's bill continues this present treatment, providing that the amount taxed as capital gain at the time of the distribution of the stock (namely the employer's contribution plus the earnings on his and the employee's contributions) is to be a class B capital gain without regard to how long the property distributed had been held. Subsequently, if the employee sells the stock, the appreciation in this stock to the extent attributable to the period prior to the time of the distribution to the employee will also be treated as class B capital gain. However, any appreciation in value of the stock attributable to the period of time after the distribution will be eligible for class A capital gains treatment where the stock has been held for more than 2 years. Where the amount realized by the employee upon the sale of the stock is less than his basis for the stock plus the appreciation of the stock before distribution to him, the amount of the capital gain will be only the amount in excess of his basis for the stock, even though this is less than the amount of the unrealized appreciation at the time of the distribution of the stock to him.

(c)(iii) *Effective date.*—Generally, the capital gains (and losses) provisions in this bill are applicable to taxable years beginning after December 31, 1963. The lump-sum distribution amendment applies to amounts paid to the employees in their taxable years beginning after December 31, 1963. However, the rule concerning appreciation of employer stock before the time of distribution (which is taxable at the time of the sale of the stock by the former employee) applies with respect to securities sold or otherwise disposed of in taxable years beginning after December 31, 1963, without regard to when such securities were distributed.

(d) *Revenue effect.*—The decrease from 50 percent to 40 percent of the net capital gains included in the tax base and the lower alternative maximum capital gains rate of 21 percent will eventually result in a loss in revenue. It is estimated that given today's income levels, this loss eventually will amount to $90 million a year. However, because these provisions are expected to "unlock" capital gains in the market now where otherwise the stocks, etc., would not be sold, it is anticipated that for several years this provision will result in a revenue gain rather than a revenue loss. Thus, it is estimated that for the calendar year 1964 increased tax liabilities resulting from this provision will amount to $340 million and in 1965 to $210 million. The provision for an indefinite carryforward of capital losses is expected to decrease liabilities by $30 million a year. Thus the combined effect of these provisions is expected to result in an increase in 1964 of $310 million, another increase in 1965 of $180 million and eventually a reduction of $120 million.

24. Dispositions of depreciable real estate (*sec. 220 of the bill and sec. 1250 of the code*)

(*a*) *Present law.*—Under present law, taxpayers may take depreciation on real property (other than land) used in a trade or business or held for the production of income. The depreciation methods available are the same as those applying to tangible personal property. They include: (1) Straight-line depreciation; (2) 150 percent declining balance depreciation; (3) double-declining balance depreciation; (4) sum-of-the-years-digits depreciation; and (5) any other consistent method of depreciation which does not during the first two-thirds of the useful life of the property result in greater depreciation than under the double-declining balance method. The 150 percent declining balance method is available with respect to used real property only under certain circumstances. The last three methods of depreciation referred to are available only for property with a useful life of 3 years or more and only if the property was new property in the hands of the taxpayer.

The depreciation is allowed as a deduction against ordinary income. As the depreciation deduction is taken the cost or other basis of the real property is reduced by a like amount. If the property subsequently is sold, any gain realized on the difference between the sales price (adjusted downward for selling expenses) and the adjusted basis of the property is taxed as a capital gain if the total transactions in depreciable property and certain other property (referred to in sec. 1231) result in a gain for the year involved. On the other hand, where the aggregate of these transactions results in a loss, the net loss is an ordinary loss.

(*b*) *General reasons for provisions.*—Since the depreciation deductions are taken against ordinary income while any gain on the sale of the property is treated as a capital gain, there is an opportunity under present law in effect to convert ordinary income into capital gain. This occurs whenever the depreciation deductions allowed reduce the basis of the property faster than the actual decline in its value.

Last year Congress in the Revenue Act of 1962 recognized the existence of this same problem in the case of gains from the disposition of depreciable machinery and other personal property In that act, the Congress provided that any gain realized on the sale of these assets in the future would be ordinary income to the extent of any depreciation deductions taken in 1962 and subsequent years with respect to the property.

In the case of real estate, this problem is magnified by the fact that real estate is usually acquired through debt financing and the depreciation deductions allowed relate not only to the taxpayer's equity investment but to the indebtedness as well. Since the depreciation deductions relate to the indebtedness as well as the equity in the property, this may permit the tax-free amortization of any mortgage on the property. As a result in such cases there is a tax-free cash return of a part of the investment which may in fact enable the taxpayer to show a loss for several years which he may offset against income for tax purposes.

Last year, your committee did not include real property in the recapture provision applicable to depreciable personal property

because it recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time. Your committee's bill this year takes this factor into account. It makes sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed the deduction which would have been allowable had the taxpayer limited his deductions to those available under the straight-line method of depreciation. Secondly, your committee has added a provision which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate. As a result, under your committee's bill, no ordinary income will be realized on the sale of real estate held for more than 10 years.

(c) *General explanation of provisions.*—In view of the considerations set forth above, your committee has amended present law to provide that when depreciable real estate is sold after December 31, 1963, in certain cases a proportion of any gain realized upon the sale of the property is to be treated as ordinary income; that is, previous depreciation deductions against ordinary income are to be "recaptured" from the capital gains category.

The bill accomplishes this result by treating as ordinary income a certain percentage of what is called "additional" depreciation or the amount of gain realized on the sale of the property, whichever is smaller.[1] Generally, the "additional" depreciation referred to here is that part of the depreciation deductions which exceeds the depreciation deductions allowable under the straight-line method. The depreciation deductions taken into account, however, are only those taken after December 31, 1963. Thus, they are the excess of any depreciation deductions taken under the double-declining balance method, sum-of-the-years-digits method, or other method of rapid depreciation, over the depreciation which would have been taken under the straight-line method. In the case of property held for 1 year or less, however, the deductions recaptured are to include not only the excess over straight-line depreciation, but rather the entire depreciation deductions taken.

Your committee generally has limited the depreciation recapture to the excess over straight line depreciation because it believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains. Moreover, your committee believes that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation

[1] This provision also applies to certain dispositions where there is not a sale or exchange. Therefore, the bill refers not only to the excess of the amount realized over the adjusted basis of the property but also, so that the provision will apply to these dispositions which are not sales or exchanges, it refers to the excess of the fair market value of the property over its adjusted basis.

deductions. For that reason, your committee's bill also tapers off over a 10-year period the proportion of the additional depreciation (or gain where smaller) which is to be treated as ordinary income upon the sale of the property.

This is accomplished by providing that the additional depreciation (or gain if smaller) which otherwise would be treated as ordinary income is to be decreased by 1 percentage point for each full month the property is held in excess of 20 full months. Thus, the amount which will be treated as ordinary income in the case of property held for a full 21 months would be 99 percent (the applicable percentage) of the amount which otherwise would be so treated. This decreases 1 percent for each succeeding month the property is held until the applicable percentage decreases to zero for property held for 10 years or more.

The property which is to be given the type of treatment described above is depreciable real property other than real property which is eligible for the investment credit. Such property is already subject to the recapture rule provided by section 1245 which generally applies to tangible personal property. The types of real property, therefore, which are not subject to this provision are property other than buildings or structural components which are used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services or represent research or storage facilities used in connection with these activities. Examples of the types of real property which, therefore, are not included under this provision are railroad track and bridges and blast furnaces.

This provision applies only to the additional depreciation allowed or allowable. Consequently, the enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction for depreciation is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, is not intended to affect this holding.

(c)(i) *Substantial improvements.*—Because the percentage of additional depreciation (or gain, if smaller) decreases after the first 20 months by 1 percent a month, it is necessary to determine when property has been acquired. This presents a special problem where real estate already held is substantially improved. To consider the substantial improvement as being held for the same period as the original investment in the property would mean that where property had been held for 10 years or more there would be no ordinary income arising with respect to substantial improvements, even though these improvements might have been made within the last few years. To prevent avoidance of the ordinary income treatment provided by this provision, your committee's bill defines a "separate improvement" which is treated as a separate element for purposes of determining the amount treated as ordinary income upon the sale or exchange of real property. Appreciation which may be treated as ordinary income is divided up among the separate elements in accordance

with the additional depreciation deductions with respect to each element.[1]

A separate improvement is intended by the bill to be only an improvement which is of a substantial nature. Lesser improvements are treated as if they were a part of the original structure and do not take a new, or separate holding period for purposes of determining the proportion of the additional depreciation (or gain, if smaller) treated as ordinary income. As a result, separate improvements are defined under the bill as arising only where the cost of the improvements in question is greater than the largest of the following three amounts—

1. 25 percent of the adjusted basis of the property;
2. 10 percent of the original cost of the property plus the cost of any improvements made prior to those being considered here less the cost of retired components; or
3. $5,000.

These tests are applied over a 3-year period. Thus, if improvements made in any 3-year period increase the adjusted basis of the property before that period by 25 percent or more or exceed the amount specified under the other tests if larger, then this entire amount will be treated as a separate improvement. The 25-percent adjusted basis test in this case is expected to be the principal test applied; however, the 10-percent test will prevent a relatively moderate improvement in a fully, or almost fully, depreciated building from being classified as a substantial improvement. The $5,000 limitation is intended as a de minimis rule below which no aggregate amount in a 3-year period would be treated as a substantial improvement.

In applying the above test for determining whether an improvement is to be treated as substantial, improvements in any one of the 3 years are to be omitted entirely if they do not amount to at least $2,000, or 1 percent of the original cost of the property plus the cost of any improvements previously made (less the cost of retired components), whichever is the greater. As in the case of the $5,000 limitation, which applies over the 3-year period, these exceptions are designed as a de minimis rule to make it unnecessary to treat as separate improvements relatively minor improvements made in any one of the 3 years which may be involved in the computation in question.

In the future additional depreciation allowed over straight-line depreciation is to be subject to recapture not only in the case of the double-declining balance and other forms of rapid depreciation available only in the case of new property, but also the excess over straight-line depreciation is to be recaptured in the case of depreciation, such as the 150 percent declining balance depreciation which presently is permitted with respect to used real property under certain circumstances.

(*c*)(*ii*) *Disposition where ordinary income is recognized.*—Ordinary income under your committee's bill is recognized not only in the case of the sale or exchange of real property but also in the case of all other types of dispositions unless a specific exception is provided. Thus, as in the case of the provision enacted last year in connection with tangible personal property, this provision may result in the realization

[1] In addition to the separate improvements, the bill also treats as separate elements units of real property which were placed in service at different times before initial completion of the building.

of ordinary income even though capital gain might not otherwise have been realized at the time of such a disposition. The bill provides seven general categories of exceptions, however, where dispositions are not to result in the recognition of any ordinary income.

The first exception is for gifts. Thus, the making of a gift for this purpose will not be a taxable event. However, the depreciation deductions of the donor in such a case are carried over to the donee. As a result, if the donee subsequently sells the real property, there may be ordinary income recognized by him as a result of depreciation deductions taken by the donor. The donee in such a case, however, will receive the benefit of the holding period of the donor. The effect, therefore, of this is to treat the donor and donee for purposes of this provision as if they were one person, with the result that upon the subsequent sale by the donee of the property, the same amount (if any) will be treated as ordinary income as if the donor held the property throughout the entire period. Similarly, in determining the percentage decrease in total gain to be taken into account as ordinary income, the holding period of both the donor and the donee is taken into account. This, of course, means that a smaller proportion of the gain will be treated as ordinary income than would be true if only the donee's holding period were used for this purpose.

In the case of real property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the bill provides that the amount of the charitable contribution deduction he may receive is reduced by the amount which would have been treated as ordinary income had the real property been sold at its fair market value (amendment to sec. 170(e)). This conforms with the treatment provided last year by Congress with respect to tangible personal property contributed to a charity.

A second exception to the recognition of ordinary income upon the disposition of real property is provided in the case of transfers at death (except where the sale has occurred before death, in which case the amount is treated as income with respect to a decedent under sec. 691). In this case, however, there is no carryover of the income potential of the depreciation deductions to the decedent's devisee or heir.

A third category of exceptions to the recognition of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis of the real property is carried over from the former to the new owner. However, in these transactions where there is any gain recognized because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of this gain, ordinary income may be recognized or to the extent of the applicable percentage of the additional depreciation deductions if smaller. The tax free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); the case of a transfer of property by a corporation which is a party to a reorganization in pursuance of a plan of reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (secs. 371(a) and 374). Also included in the same category are contributions of real property to a partnership in exchange for an interest in the part-

nership, and distributions by a partnership of real property in partial or complete liquidation of an interest in the partnership (but in this respect, see the special partnership treatment described below). Under your committee's bill, however, there will be a recognition of ordinary income where there is a contribution of depreciable property to a tax exempt organization (other than an exempt farm cooperative) in exchange for stocks or securities in the exempt organization. Recognition of gain in this case, as in the case of tangible personal property in the provision added last year, is provided because a disposition of the property by the exempt organization ordinarily would escape the realization of the ordinary income with respect to these deduct ons.

A fourth category of exceptions is provided in the case of so-called like-kind exchanges of real property used for production or investment and for involuntary conversions. In exchanges of these types, the ordinary income realized is in general limited to any appreciation in value attributable to depreciable real property which is not reinvested, after the exchange or involuntary conversion in other into depreciable real property. Thus, ordinary income will be realized to the extent of the additional depreciation, decreased according to the holding period involved, or by the following amount of appreciation, whichever is the smaller. First, to the extent that the exchange or conversion results in actual gain being recognized, this will be treated as ordinary income under the general rule. Second, this gain will be increased by stock purchased in a corporation even though under the involuntary conversion provision this generally would not result in the realization of gain. This amount is treated as potential ordinary income since any subsequent sale of the stock does not represent the sale of a depreciable asset and, therefore, it would not be possible in this event to recapture the depreciation. Third, to the extent of any remaining appreciation represented by real property, ordinary income is realized to the extent this unrealized appreciation cannot be included in the basis of the newly acquired real property. Under this provision, the newly acquired real property will, upon its sale or other disposition, give rise to the same ordinary income as would the previously held real property (except to the extent that ordinary income was recognized at the time of the conversion). The holding period for purposes of determining the percentage of the additional depreciation which is to be treated as ordinary income is begun anew with respect to the exchange or converted property, but the new holding period applies only to the percentage of the gain which would have been taken into account had the property previously held been sold at the time of the exchange or conversion.

A fifth exception is provided in the case of the exchange or sale or property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases, also, the ordinary income includes not only the actual gain recognized but also the appropriate percentage of any depreciation charges unrecovered at the time of the sale or exchange which are not reinvested in other depreciable real property.

A sixth exception is provided in the case of distributions of real property by a partnership to a partner. A distribution of real property by a partnership to a partner, to the extent that the distribution represents the partner's share of unrealized appreciation attributable to this property, is not to result in ordinary income to the

distributee partner at the time of the distribution. However, the unrealized appreciation representing additional depreciatoin taken by the partnership will be carried over to the distributee partner. When he disposes of this real property, the unrealized appreciation represented by these partnerships (or by an earlier transferee where the partnership acquired the property without recognizing gain), additional depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. This rule applies only to the extent a partner is considered as receiving his share of the real property to which is attributable potential ordinary income. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in real property is to be considered as "unrealized receivable." Thus, to the extent of applicable percentage of the additional depreciation deductions taken (or potential gain, if smaller) ordinary income will be recognized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of real property reflecting this ordinary income.

A seventh exception deals with the case where the property being disposed of by the taxpayer is his principal residence. Under present law (sec. 1034) where the taxpayer sells his principal residence and within a year before or after this sale (18 months after in the case of the construction of a new home) purchases or builds another, then any gain realized on the sale of the first residence is not recognized for tax purposes to the extent the total proceeds from the sale of the first residence are invested in the second. Your committee's bill provides that in cases of this type, to the extent the full proceeds from the sale of the first residence are reinvested into a second, no ordinary income is to be recognized at that time. Moreover, in such a case, the ordinary income potential in the first property is not to be carried over to the second residence. Since depreciation deductions are taken only with respect to business properties or properties held for the production of income the likelihood of such amounts being involved where one personal residence is sold for another is sufficiently rare as to make the possible revenue which would arise from a carryover of such deductions not worth the complications involved.

Similarly, your committee's bill provides no carryover of ordinary income potential with respect to the provision incorporated elsewhere in this bill (sec. 206 of the bill) which provides that no gain is realized by a taxpayer age 65 or over who sells a home which he has used as a personal residence and owned for 5 out of the last 8 years.

As in the case of the provision enacted last year relating to tangible personal property, your committee in this provision found it necessary to recognize ordinary income in cases where capital gain is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value; namely, where the real property is distributed as a dividend (sec. 311), where the real property is distributed as part of a partial or complete liquidation by a corporation (sec. 336), and where in a plan of

complete liquidation a corporation sells the real property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the real property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholder in a liquidation under section 337 (12-month liquidation) results under this bill in the recognition of the same amount of ordinary income of the corporation as would have been realized on a cash sale of these notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the real property to the receiving shareholder is determined under section 344(b)(2) (purchase of 80 percent of the stock of one corporation by another corporation followed by immediate liquidation of the corporation acquiring). The other situations where ordinary income may be realized under this provision although capital gain would not otherwise occur, include the case where distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this real property. Other cases include the provision relating to the exchange of like-kind property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases where the property received in exchange for depreciable real property is not itself depreciable real property, then ordinary income is recognized.

(*c*)(*iii*) *Leasehold improvements.*—Improvements made to property held under a lease by a lessee present a special problem in determining what is the amortization period equivalent to the straight-line depreciation method selected as the norm in the usual case. Present law (sec. 178) in general provides that leasehold renewal periods are to be taken into account in determining amortization or depreciation with respect to any year if the initial lease period remaining is less than 60 percent of the useful life of the building or other improvement, or if less than 75 percent of the cost of the lease is attributable to the remaining portion of the initial lease period, and if it is more probable that the lease will be renewed, extended, or continued than that it will not. Such a test is appropriate when looking forward to amortization deductions in future years. However, it does not represent an adequate norm for the measurement of excess or additional depreciation after the deduction have been taken and the lease is being sold.

As a result, the bill provides that in determining the norm for purposes of specifying additional depreciation which may be treated as ordinary income, periods for which a lease may be renewed, extended, or continued under an option exercisable by the lessee are generally to be taken into account. However, the renewal periods so taken into account are not to extend the amortization period by more than two-thirds of the initial lease period remaining after the improvement was made. Thus, in the case of a 6-year lease with a 6-year renewal period, only 4 additional years are to be taken into account in determining the amortization period of an improvement made at the beginning of the initial lease. Thus, in this case, the amortization payments with respect to the lease would be spread over a 10-year period and payments in excess of such a spreading would be considered additional depreciation adjustments. However, if the useful life of the asset itself in such a case were less than 10 years, then the deprecia-

tion deductions would be spread for this purpose in a straight-line method over the useful life of the asset, and this would be used as the measure in determining additional or excess depreciation adjustments.

(*c*)(*iv*) *Effective date.*—This provision is to apply with respect to depreciation attributable to periods after December 31, 1963, and to dispositions of property after that date.

(*d*) *Revenue effect.*—Since this provision relates only to depreciation deductions in 1964 and subsequent years, the initial revenue impact of this bill is expected to be small. Thus, in fiscal year 1965, it is expected that this provision will result in a revenue gain of less than $2.5 million. In subsequent years, however, when the provision becomes fully effective, it is anticipated that it will result in a revenue gain of approximately $15 million a year.

25. Income averaging (sec. 221 of the bill and secs. 1301–1305 of the code)

(*a*) *Present law.*—Present law does not provide any generally available income averaging provision for the persons whose income fluctuates widely from year to year. Instead, present law contains six specific averaging provisions dealing with special types of situations: Certain compensation for personal services, income from inventions or artistic work, certain income from back pay, compensation for damages for patent infringements, breach of contract damages, and damages for injuries under the antitrust laws.

In the case of the provision relating to compensation for personal services and that relating to inventions and artistic works, in order to be eligible for this treatment, the employment involved must have covered 36 months or more in the case of the compensation for personal services, and in the case of the work on the inventions or the artistic works must have covered a period of 24 months or more. In addition, eligibility under these same two provisions required that the receipts of the payments involved with respect to the work be heavily concentrated in 1 year. In the case of compensation for personal services, 80 percent or more of the total compensation for the employment must have been received in the taxable year in question. In the case of the invention or artistic work, the amount received in the year in question must not be less than 80 percent of the gross amount received with respect to the invention or artistic work in the taxable year, all prior years and the succeeding 12 months. The back pay provision also has a somewhat similar provision. To be eligible for averaging in the case of back pay, the amount of back pay received in the taxable year must exceed 15 percent of the gross income for that year.

In the case of all of the present averaging devices, the averaging is achieved by providing that the tax involved is not to be greater than if this income were spread back, either ratably over the period to which the income relates, or to the specific years to which the income relates. However, in the case of income from inventions, the spread back for this purpose may not exceed 60 months, and in the case of artistic work it may not exceed 36 months. The other averaging provisions are not limited in this respect. The tax in each case, although imposed as of the current year, is determined by making a recomputation with respect to one or more back years.

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(*b*) *General reasons for provisions.*—A general averaging provision is needed to accord those whose incomes which fluctuate widely from year to year the same treatment accorded those with relatively stable incomes. Because the individual income tax rates are progressive, over a period of years those whose incomes vary widely from year to year pay substantially more in income taxes than others with a comparable amount of total income but spread evenly over the years involved. This occurs because the progressive rates take a much larger proportion of the income in taxes from those whose incomes in some years are relatively high. The absence of any general averaging device has worked particular hardships on professions or types of work where incomes tend to fluctuate. This is true, for example, in the case of authors, professional artists, actors, and athletes as well as farmers, fishermen, attorneys, architects, and others.

The present averaging provisions have proved unsatisfactory, first, because they are limited to a relatively small proportion of the situations where averaging is needed. Thus, while they presumably cover inventors and writers, they do not provide for actors, athletes, and in most cases do not provide for attorneys, architects, and others. Even in the case of inventors and authors, the present provision is inadequate because of the requirement that the income arise over at least a 24-month period and 80 percent or more of the income from the invention or work be concentrated in the current year in question. In practice, many cases involving authors and inventors where averaging is needed do not meet these specific requirements. This was made clear to your committee in testimony from authors and others during its hearings on this bill.

The present averaging provisions also have proved unduly complicated in practice because of the requirement that the prior years incomes and taxes must be recomputed as if the income had actually been received in those prior years.

Income averaging, in your committee's view, should be designed to treat everyone as nearly equally for tax purposes as possible, without regard to how their income is spread over a period of years and without regard to the type of income involved. At the same time, it is necessary to have any income averaging device in a form which is workable, both from the standpoint of the taxpayer and the Internal Revenue Service.

Although your committee's bill generally repeals the averaging devices in present law (secs. 1301–1307), the committee recognizes that cases may arise where a person has entered into long-term contingent employments upon the assumption that the averaging device in present law applicable to compensation from an employment would be available. Since employments in some cases may last for extended periods of time, such as 20 years, the general 5-year averaging device might produce less favorable treatment than the present provision. Your committee concluded that it would be appropriate in the case of these long-term employments, which were already in being before your committee began hearings on this matter, to permit the taxpayers involved to continue the form of averaging available under present law if they elect to forego the general 5-year averaging provided in this bill.

(*c*) *General explanation of provisions.*—In view of the considerations set forth above, your committee's bill deletes all of the averaging pro-

visions in present law referred to previously and substitutes instead an income averaging device available to individual taxpayers generally, substantially without regard to the source of the income. As indicated subsequently, however, in the case of the averaging device for compensation from an employment, your committee's bill in certain cases permits the continuance of the application of this provision.

Under the averaging rule provided by the bill, once the amount of income to be averaged is determined—called averageable income in the bill—and assuming this amount is more than $3,000, the taxpayer is to compute a tentative tax on one-fifth of this amount. The tax on this one-fifth is determined by adding this one-fifth to 1⅓ times the average income received in the prior 4 years, plus the average capital gains income in this same 4-year period. The tax attributable to this one-fifth is then multiplied by 5 to determine the final tax on this income.

Averaging is available only where the "averageable income" exceeds $3,000 because, with the present progressive rate structure with tax brackets usually of $2,000 to $4,000, smaller amounts achieve little if any benefit from averaging. The device of including one-fifth of the averageable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this result by 5, achieves a result which is substantially similar (except when there are rate changes during the 5 years) to including one-fifth of the income eligible for averaging in the taxable income base of each of the prior 4 years and of the current year. The advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the 4 prior years in order to obtain this result.

The "averageable income" referred to here is the excess of the taxable income in the current or computation year—with certain adjustments—over 1⅓ times the average base period income. The average base period income is the average of the taxable income in the 4 prior years with certain adjustments specified below.

Averageable income is limited to that which is in excess of 1⅓ times average income in the base period for two basic reasons. First, in any new provision of this type, it is necessary to limit the number of cases to which the new provision will apply to a manageable level from the administrative standpoint. In other words, it was necessary initially, at least, to limit the volume of cases where averaging will be applied. Moreover, it is clear that the greatest need for averaging occurs where the fluctuation in income levels varies widely. An increase of more than one-third from the prior average income was selected to make the new averaging rule available in those cases where it is needed the most.

As indicated above, in computing the income subject to averaging, it is necessary to make some adjustments in both the income of the current, or computation year, and also in the income of the 4 base period years with which the current year's income is compared. The income of the computation year, referred to in the bill as the "adjusted taxable income" is the taxable income for that year decreased by; (1) Any capital gain net income for that year; (2) any income for that year attributable to gifts, bequests, devises, inheritances received during that year or any of the four prior base period years; [1] (3) any

[1] Income attributable to gifts, bequests, devises, or inheritances between a husband and wife are not taken out of the income for the computation year if they file a joint return for the computation year or one of them makes a return in that year as a surviving spouse. Also not taken into account are amounts of less than $3,000 in computation year.

excess of wagering gains in the year over wagering losses; and (4) certain amounts of income to which penalties apply with respect to owner employees who are self-insured for pension plan purposes (sec. 72(m)(5)).

Class A and class B capital gains are excluded from the income subject to averaging in the computation year on the grounds that such income does not require averaging because of the fact that only 50 or 40 percent of the capital gain income is included in the tax base in any event. Moreover, without regard to the averaging provision, such income is subject to a maximum rate of 21 or 25 percent.

Averageable income also excludes income from gifts, devises, or inheritances where the gifts, etc., have been received either in the computation year or in any of the four prior base period years, because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. In addition, in the case of the transfer by gift of income producing properties between related parties, there would be some opportunity for manipulation if such income were not excluded from that which can be averaged. Income attributable to such property is excluded under your committee's bill only where it is in excess of $3,000 in the computation year. Also, because it may be difficult to trace specific income to specific gifts, bequests, devises, or inheritances, the bill presumes that such property earns a 6-percent rate of return unless the taxpayer establishes to the satisfaction of the Treasury that some other amount of income is earned with respect to the property.

Net wagering gains are excluded from averageable income to prevent such income from receiving a preferred status. For similar reasons, penalty income of owner-employees in the case of self-insured pension plans is excluded.

It is also necessary to make some adjustments in the base period income with which the adjusted taxable income for the computation year is compared. Two of these adjustments are the same as those made in the computation year. Thus, capital gain net income for the base period year is excluded and also any income from gifts, bequests, devises, or inheritances where such property was initially received by the taxpayer in 1 of the 4 base period years.

A third adjustment made to the average base period income is to add back to such income any income excluded from the taxpayer's base in such year on the grounds that it was earned in a foreign country (the exclusion under sec. 911 of present law) or on the grounds that it was income from sources within a possession of the United States (sec. 931 of present law). The inclusion of such amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging.

(*c*)(*i*) *Example.*—For most taxpayers with little or none of the income which gives rise to the special exceptions described above the application of this averaging provision is relatively simple. This can be illustrated by an example of an unmarried taxpayer having an average base period income of $3,000 in the years 1961–64 and an

adjusted taxable income of $44,000 in 1965. The taxpayer in this case is eligible for averaging since his "averagable income" exceeds $3,000. His averagable income in this case can be computed as follows:

1. Adjusted taxable income in computation year	$44, 000
2. 133⅓ percent of average base period income ($3,000×133⅓ percent)	4, 000
3. Averagable income	40, 000

Since the averagable income is in excess of $3,000, the entire amount is subject to averaging.

Computation of tax:

(*a*) 133⅓ percent of average base income ($3,000×133⅓ percent)	4, 000
(*b*) Averagable income included in tentative tax base (⅕ of $40,000)	8, 000
(*c*) Tentative taxable income	12, 000
(*d*) Total tentative tax liability (1965 rates under bill)	2, 830
(*e*) Tax on $4,000 not subject to averaging	690
(*f*) Tax liability on ⅕ of averagable income	2, 140
(*g*) Tax on total averagable income ($2,140×5)	10, 700
(*h*) Total final tax liability (tax on $4,000 not subject to averaging and $40,000 subject to averaging)	11, 390
(*i*) Tax on $44,000 under 1965 rates without averaging	18, 990

(*c*)(*ii*) *Treatment of capital gains and priority of taxing different types of income.*—As previously indicated, net capital gains—any excess of class B or class A gains over capital losses—are excluded from the adjusted taxable income for the computation year in determining how much of this income is to be eligible for averaging and also from the average base period income. Thus, generally, capital gains (other than short-term capital gains) have no effect in determining the income subject to averaging. There is one exception to this general rule, however. If the average capital gain net income in the base period exceeds the capital gain net income in the computation year, then to the extent of this excess the income subject to averaging is reduced. Generally, it was thought that capital gains should be set apart and not taken into account in averaging since they, in effect, have their own specialized form of averaging. However, in those cases where the average capital gains in the base period exceed the capital gains in the computation year, it is believed that averaging should be permitted only when total taxable income of the current year is substantially greater than the average of the base period.

Your committee's bill provides that in determining the tax which is attributable to the income subject to averaging, the first income subject to tax is to be the ordinary income not eligible for averaging. In the example previously presented, this meant that the $4,000 of income not subject to averaging was considered to be the income subject to the first income brackets. The income subject to the next higher income rates is the capital gain net income of the computation year but only to the extent [1] this does not exceed the average base period capital gain net income. Following this is the income subject to averaging, with respect to which one-fifth is included, the tax then computed, and the result multiplied by 5. Any remaining capital gains income in the computation year, in excess of average base period capital gain net income, is treated as coming on top of this income subject to averaging along with income from wagering or gifts, be-

[1] Actually this amount is preceded by any excess of average base period capital gain over capital gains of the computation year in those infrequent cases where such income exists.

quests, devises, or inheritances, which is not eligible for the averaging treatment.[2]

The alternative capital gains tax in such a case is determined by applying the appropriate 21 or 25 percent (or combination of the two rates) to the class A or class B capital gains. This tax then is compared with the tax attributable to the capital gains in the computation explained above. The reason for structuring the tax base in the manner indicated is to give assurance that the income subject to averaging is taxed, as nearly as possible, at the same income level as would be the case had such income been earned ratably over the current year and 4 prior years.

(c)(iii) *Eligible individuals.*—To be eligible for averaging, one of the principal concerns is that the individual's income must have been subject to tax by the United States throughout the entire base period as well as the computation year. No one is eligible for averaging who was a nonresident alien in any of the 4 base period years or in the computation year. To be eligible for averaging, the individual must be a citizen or resident in the computation year. In addition, even though a citizen in the computation year, the individual must be claiming no exclusion in that year for income earned abroad. He may have claimed such an exclusion with respect to a base period year, but, for purposes of determining his income in the computation year subject to averaging, this income is added back to his base period income.

A second concern of this provision is that the individual be a member of the labor force in both the computation year and in the 4 base period years. It has been necessary, however, to approximate this result in some cases. The general rule provides that the individual and his spouse must have furnished one-half or more of his own support in each of the base period years. However, it was not intended to exclude from the benefits of the averaging provision an individual who, although in the labor force, was unemployed in part or all of the base period years. For that reason, individuals generally are eligible for averaging if they are 25 years old and there have been at least 4 years since the individual attained age 21 when he was not a full-time student. Thus, generally, individuals age 25 or over will be eligible for averaging so long as they have been out of school for at least 4 years since age 21. A second exception is provided for the individual who, although not self-supporting in the 4-year base period, nevertheless, has income in the current year more than half of which is attributable in substantial part to work he has done in two or more of the base period years. This is designed to make sure that those who have performed some work of a substantial nature which occurred over a period of years will be eligible for averaging even though below the 25-year age limit. A third exception is provided for an individual who was not self-supporting in the base period and who makes a joint return with someone else if not more than 25 percent of the total adjusted gross income of the couple in the computation year is attributable to the individual in question. This means that an individual who has been in the labor force and who marries someone who was a dependent of another will not be deprived of averaging, assuming three-quarters or more of the income in the computation year is

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[2] The penalty income with respect to owner-managers in connection with receipt of pension-type income is treated as if the averaging provision did not apply.

attributable to the individual who was in the labor force in the base period. This is designed to assure that a man who marries a woman who was a dependent of her father during part or all of the base period years is not deprived of income averaging as a result of this marriage.

(*c*)(*iv*) *Special rule with respect to marital status.*—No problems arise in applying the averaging provision where a husband and wife file a joint return in the computation year and also did so in each of the base period years. However, it is necessary to reconstruct their income where they either file separately (or with other spouses) in the base period years or are filing separately in the computation year. For example, if a married couple files a joint return in the current year but filed separate returns for one or more base period years, their base period income for purposes of averaging in the current year will be their combined base period incomes for their base period years. In addition, the bill provides that an individual's base period income is to be either his actual base period income in each of the base period years or, if higher, 50 percent of the combined base period income of him and his spouse.[1] In determining actual income for purposes of this provision, community property laws are not to be taken into account with reference to income from personal services. Thus, the actual income attributed to an individual will be the income earned by him without regard to whose income it is considered to be under community property law.

(*c*)(*v*) *Continuance of present averaging device in certain cases.*—Your committee's bill provides that the averaging device in present law with respect to compensation from an employment is to continue to be available if the taxpayer so elects where he receives or accrues compensation from employment which began before February 6, 1963. If the taxpayer elects this treatment he must forgo for that year the generally available averaging device.

This provision, which on this elective basis is continued for compensation for the employment begun before the specified date, provides in general that the employment must cover a period of 36 months or more and that the gross compensation from the employment received by the individual (or partnership) in the year in question must not be less than 80 percent of the total compensation for such employment. Where these conditions are met, present law provides that the tax is not to be greater than if the compensation had been included in the gross income of the individual ratably over the period of the employment prior to the date of the receipt or accrual.

(*c*)(*vi*) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This means that averaging will be available for the first time with respect to taxable years beginning in 1964. This will involve base period years as far back as 1960. However, as indicated previously, the averaging device in present law relating to compensation from employment where the employment began prior to February 6, 1963, may continue to be applicable for taxable years beginning after December 31, 1963, at the election of the taxpayer.

(*d*) *Revenue effect.*—This provision is expected to result in a reduction of $40 million of tax liabilities in the calendar year 1964 and subsequent years.

[1] If the individual involved was married to another person in one or more of the base period years, his base period income is to be not less than 50 percent of his income in that year combined with the income of whichever spouse had the higher income.

26. Repeal of additional 2-percent tax for corporations filing consolidated returns (sec. 222 of the bill and sec. 1503 of the code)

(*a*) *Present law.*—Under present law a consolidated income tax return may be filed by a group of parent and subsidiary corporations where there is 80 percent control of each level of the chain of corporations, and there is a common parent corporation; 80 percent control, in this case, means 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock. In the consolidated return, intercompany transactions are washed out, and it is possible to offset losses of one corporation against the gains of other members of the group. These intercompany transactions which are washed out also include intercompany dividends. As a result, dividends may be paid from one company in a consolidated group to another of the same group without the second member including in its income 15 percent of this dividend income.

Under present law, where the election to file a consolidated return is made, a special tax is levied equal to 2 percent of the consolidated taxable income of the group.

(*b*) *General reasons for provision.*—Your committee's bill removes the special 2-percent penalty tax on the privilege of filing a consolidated return, in part because the return of commonly controlled corporations as a single economic unit for tax purposes is in accord with the reality of the situation. Moreover, there appears to be no reason why, where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere presence of more than one corporate organization in the group should result in any penalty tax. No such penalty, for example, is exacted in the case of other corporate organizations operating through divisions rather than separate corporations.

In addition, the removal of this 2-percent penalty tax should encourage the filing of consolidated returns and serve as a brake on the expansion of the use of multiple surtax exemptions to gain tax advantages.

(*c*) *General explanation of provision.*—In view of the considerations set forth above, your committee's bill repeals the special 2-percent tax on consolidated returns, effective with respect to taxable years beginning after December 31, 1963. This 2-percent tax presently applies to the consolidated taxable income of the affiliated group of includible corporations.

(*d*) *Revenue effect.*—The repeal of the 2-percent tax on consolidated corporate returns is expected to decrease revenues by $50 million a year.

27. Reduction of surtax exemption in case of certain controlled corporations (sec. 223 of the bill and secs. 1561–1563 of the code)

(*a*) *Present law.*—Under present law, corporations are taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on all income over that amount. This tax rate differential results from the fact that the first $25,000 of income of a corporation is subject to the 30-percent normal tax but is exempt from the 22-percent surtax, while income in excess of $25,000 is subject to both the 30-percent normal tax and the 22-percent surtax. This tax structure was intended to encourage small businesses which operate in corporate form. However, medium and large enterprises

have in some cases taken advantage of the lower rates afforded small business by organizing their corporate structure in multiple corporate form.

As a result, the Internal Revenue Code contains several provisions designed to prevent taxpayers from using the multiple form of corporate organization, to avoid taxes. For example, present law provides (sec. 269) that where an individual or corporation acquires control of a corporation and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, this deduction, credit, or allowance is not to be allowed. Also, elsewhere (sec. 1551) present law provides that if a corporation transfers part or all of its property (other than money) to another corporation created to acquire the property, or not actively engaged in business at the time of the transfer, and if there is common control of the two corporations, then the transferee corporation is not to be allowed the $25,000 surtax exemption or the $100,000 accumulated earnings credit unless it establishes by the clear preponderance of the evidence that the securing of the exemption or credit is not a major purpose of the transfer. In addition, present law (sec. 482) provides that where two or more corporations are owned or controlled directly or indirectly by the same interest, the Secretary of the Treasury or his delegate may allocate deductions, credits, or allowances between or among these corporations, if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations.

(*b*) *General reasons for provision.*—This bill reduces the tax applicable to the first $25,000 of taxable income from 30 to 22 percent and decreases the tax applicable to income above $25,000 from 52 to 50 percent in 1964 and to 48 percent in subsequent years. One of the effects of this change is to increase the value of a surtax exemption from $5,500 (22 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation under present law to $6,500 (26 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation for 1965 and subsequent years.

While your committee recognizes the importance to small business of reducing the tax on the first $25,000 of income from 30 to 22 percent, it also recognizes that this substantial tax reduction should not provide added inducement to existing medium and large corporations to split up into multiple corporations. Therefore, your committee has limited the benefits of the tax reduction in cases where a parent corporation owns or controls one or more other corporations, or where a single individual, trust, or estate owns or controls two or more corporations.

By limiting the benefits of the tax rate reductions in the case of groups of multiple corporations, your committee has been able to grant a substantial tax reduction to small business in reducing the normal tax rate to 22 percent, as was recommended by the President, without granting the same benefits to medium and large enterprises which use, or might choose to use, the multiple corporate form of organization. The method of taxing controlled corporations contained in the bill will, in your committee's opinion, when coupled with repeal of the 2 percent additional tax on consolidated returns, encourage some controlled groups to file consolidated returns, while

leaving groups which do not choose to file consolidated returns in approximately the same relative position they are in under present law.

While your committee recognizes the advantages of use of multiple corporations, your committee believes, as it has in the past, that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, your committee does not intend to encourage the formation of these multiple corporations and therefore proposes to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes.

(c) *General explanation of provision.*—If a controlled group exists, three basic alternatives are available to corporations which are members of the group:

(1) The corporations in the group may forego the use of multiple surtax exemptions, i.e., they each file separate income tax returns and allocate one $25,000 surtax exemption among the members of the group.

(2) Corporations in the group may elect to pay a penalty tax and file a multiple surtax exemption return. Under this election each member of the group (subject to the tax avoidance provision) may claim a separate $25,000 surtax exemption, but each must also agree to pay an additional tax of 6 percent on the first $25,000 of its taxable income. With the generally applicable rates of 22 percent on the first $25,000 of taxable income and 50 percent or 48 percent on income over $25,000, this means a total tax for such companies of 28 percent on the first $25,000 of income and 50 percent in 1964 and 48 percent in 1965 and subsequent years on income over $25,000.

(3) A controlled group which also qualifies as an "affiliated group" of corporations may, as under present law, file a consolidated income tax return.

This third alternative is similar to the first alternative in that only one $25,000 surtax exemption is available to the corporations filing the consolidated return. However, there are additional benefits in filing a consolidated return arising from the ability to declare and receive dividends between members of the group without tax, and to offset losses of one company against another.

Your committee did not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of foregoing multiple surtax exemptions and the definition of a group eligible to file a consolidated return. Several differences arise. However, many complicated problems are involved in equating the two, and many avoidance possibilities might be created if they were equated. Thus, for example, a foreign corporation doing business in the United States is included in the controlled group definition. However, if the foreign corporation is also doing business abroad and was permitted to join in a consolidated return, it could pass a dividend,

out of its foreign earnings, tax free to the domestic parent, and thus escape all U.S. taxes. Moreover, your committee is not aware of any situations in which the discrepancies in the two definitions would create a hardship. If it develops, however, that the differing definitions create a substantial hardship for certain groups subject to the penalty tax which cannot file consolidated returns, the decision would have to be reconsidered and adjustments made to the extent possible.

(*c*)(*i*) *Test of control.*—In determining whether a controlled group of corporations exists, the bill draws a distinction between a parent-subsidiary controlled group and a brother-sister controlled group. In a parent-subsidiary controlled group one corporation, called a parent corporation, owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of one or more corporations called subsidiary corporations. The parent-subsidiary controlled group also includes corporations below the first tier subsidiary level which are 80 percent owned by the other corporations in the group. For example, if corporation A owns 80 percent of the stock of corporation B, and corporation B owns 80 percent of the stock of corporation C, corporations A, B, and C constitute a parent-subsidiary controlled group.

A brother-sister controlled group exists where a single individual, trust, or estate owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of each of two or more corporations.

In determining whether a corporation, or a single individual, trust, or estate, owns 80 percent of the value or voting power of the stock of a corporation, the stock of the corporation is considered not to include nonvoting preferred stock, which more closely approximates a debt obligation than an equity interest, and treasury stock, which, from the standpoint of ownership, constitutes unissued stock. Moreover, certain outstanding stock, although owned by separate persons, could, unless neutralized for purposes of determining control, be used by some owners as a means of divesting themselves of sufficient stock to avoid the application of this section without, as a practical matter, divesting themselves of the benefits of ownership of a corporation. Therefore, in determining whether a parent-subsidiary controlled group exists, stock of a subsidiary corporation owned by (1) individuals who are 5 percent shareholders of the parent corporation, (2) officers of the parent corporation, (3) employees of the subsidiary if the stock is subject to restrictions which favor the parent or subsidiary corporation, and (4) trusts which are part of a plan of deferred compensation for the benefit of the employees of the parent or subsidiary corporation, will not be treated as outstanding stock if the parent corporation owns 50 percent or more of the value or voting power of the stock of the subsidiary. In addition, in determining whether a brother-sister controlled group exists, stock of a corporation owned by (1) a trust forming a part of a stock bonus, pension, or profit-sharing plan for the benefit of the employees of the corporation, and (2) employees of the corporation if the stock is subject to conditions which run in favor of such corporation or the common owner and which substantially restrict or limit the employee's right to dispose of stock will not be treated as outstanding stock if the individual, estate, or trust owns 50

percent or more of the value or voting power of the stock of the corporation.

In determining whether a single individual, trust, or estate owns 80 percent of the value or voting power of the stock of a corporation, such individual, trust, or estate is, in addition to the stock owned directly, considered to own stock by virtue of certain relatively limited attribution rules. The first rule provides that an individual is considered to own stock owned by his spouse. However, your committee recognizes that in many cases a husband and wife may each own and operate their separate businesses. In order to prevent attribution in such cases, which may have the effect of denying separate surtax exemptions to each corporation, an individual is not considered to own stock owned by or for his spouse if (1) the individual does not directly own stock in the corporation in which his spouse owns stock, (2) the individual is not a director or employee of such corporation and does not take part in the management of such corporation, (3) not more than 50 percent of the gross income of the corporation is derived from rents, royalties, dividends, interest, and annuities, and (4) the stock of the corporation owned by the spouse is not at any time during the taxable year subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock if such right runs in favor of the individual or his children who have not attained age 21 years.

The bill also provides limited attribution rules in cases involving other family relationships. Thus, an individual is always considered to own the stock owned by his children who have not attained age 21. However, an individual is considered to own the stock owned by his children who have attained age 21 and grandchildren only if such individual owns, directly or indirectly, more than 50 percent of the value or voting power of the stock in the corporation. Similarly, children who have not attained age 21 are considered to own the stock held by their parents, but children who have attained age 21 and grandchildren are considered to own the stock held by their parents or grandparents, respectively, only if the child or grandchild owns, directly or indirectly, more than 50 percent of the stock of the corporation. There is no attribution between brothers and sisters. Limited attribution rules are also provided in cases involving stock held by trusts, estates, and partnerships. Stock owned by a corporation, directly or indirectly, is considered to be owned proportionately by any shareholder owning a 5 percent or greater interest in the corporation. If an individual, estate, trust, or corporation owns an option to buy stock in a corporation, for purposes of ascertaining a controlled group, such "person" is deemed to own the stock covered by the option.

(*i*) (*ii*) *Method for determining existence of a controlled group of corporations.*—Determination of whether a controlled group of corporations exists is made once each year on December 31 by taking into account the stockownership of each person who owns stock in the corporation for the taxable year including such December 31. Although the determination of the corporations included within a parent-subsidiary controlled group, or a brother-sister controlled group, is made without regard to the type of corporation involved, provision is made to limit the reduction in the surtax exemption (or payment of the additional tax) to those corporations, referred to in the bill as component members, whose income tax is determined in whole or in part by reference

to the normal and surtax rates. Thus, exempt organizations which do not have unrelated business income, and foreign corporations which are subject to a flat rate tax on their income from sources within the United States, are not considered to be component members.

In order to limit reduction of surtax exemptions (or payment of the additional tax) to cases in which the common owner of the controlled group would otherwise derive the principal benefit from the allowance of the exemption, your committee has excepted from the definition of component member those corporations which are members of the controlled group for less than one-half of the days in their taxable year which precede the applicable December 31 determination date.

In addition to corporations which meet the ownership tests described above on the applicable December 31 determination date, the term "component member" also includes a corporation whose stock is not owned by the parent corporation or common owner on such December 31 but was so owned one-half or more of the number of days in the corporation's taxable year which includes the applicable December 31. The inclusion of such "additional members" as component members prevents corporations whose stock is sold before the end of the year from obtaining the benefits of an extra surtax exemption in the year in which they leave the controlled group.

Your committee's attention was also called to the fact that certain manufacturing corporations, in an effort to facilitate the retail distribution of products which they produce, enter into agreements with individuals whereby the manufacturer and the individual each contribute capital to a distributing corporation under a plan by which a portion of the compensation of the individual from the distributing corporation is applied toward the retirement of the stock held by the manufacturer. In most cases, franchised corporations of this type are, by definition, excluded from a controlled group due to the fact that the manufacturer owns less than 80 percent of the value and voting power of the stock of the distributing corporation. However, in some cases the corporate structures of these corporations are arranged in a manner which results in the parent corporation, or common owner, owning more than 80 percent of the vote, but not more than 80 percent of the value, of the stock of the distributing corporation. Your committee believes that it would serve no useful purpose to cause these corporations to reorganize their corporate structures and has, therefore, excluded them from the definition of the term "component member" of a controlled group.

Finally, due to the nature of the business conducted by life insurance companies, and the fact that a life insurance company is not permitted to file a consolidated return other than with another life insurance company, a life insurance company is excluded from the definition of a "component member" of a controlled group unless the controlled group contains two or more life insurance companies, in which case the life insurance corporations are treated as component members with respect to each other since they may then elect to file a consolidated return with each other. A mutual insurance company, other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 821, which is included in a controlled group is also excluded from the definition of a "component member."

(*c*) (*iii*) *Privilege of groups to elect multiple surtax exemptions.*—The bill provides that the component members of a controlled group of corporations may elect to have each component member of the controlled group claim a separate surtax exemption in lieu of having one surtax exemption apportioned among such members. However, if the component members of a controlled group so elect, the income tax on each member is increased by 6 percent on so much of its taxable income which does not exceed $25,000. For example, assume individual A is a common owner of a brother-sister controlled group of corporations consisting of corporations X and Y. Further assume that corporations X and Y each have taxable income of $35,000 and that they elect to have each member claim a separate surtax exemption and pay the additional 6 percent. By taking separate surtax exemptions, each corporation would pay a total tax of $7,000 on the first $25,000 of income (28 percent, consisting of a 22 percent normal tax and a 6 percent additional tax), and a tax of $4,800 on the remaining $10,000 of income (48 percent, consisting of a 22 percent normal tax and a 26 percent surtax), for a total tax on each corporation of $11,800. On the $70,000 combined income of the controlled group this would be a tax of $23,600. Alternatively, if the group did not make the election, the total tax on the controlled group would be $27,100 (22 percent of the first $25,000 of income and 48 percent on the remaining $45,000 of income). Under these circumstances, corporations X and Y presumably would choose separate surtax exemptions with the penalty tax, rather than apportioning a single surtax exemption between the component members of the controlled group.

For the component members of a controlled group to elect to claim multiple surtax exemptions, all component members of the group must join in the election. Such an election must be made within 3 years after the date when the income tax return is required to be filed for the taxable year of the component member of the controlled group whose taxable year ends first on or after the December 31 for which the election applies. An election once made may be terminated by the consent of the members, by the refusal of a new member of the controlled group to consent, by the filing of a consolidated return by any component members of the group, or by the termination of the group. Once an election is terminated, the bill provides that the group may not again elect multiple surtax exemptions until the expiration of 5 years. In the case of reorganizations involving groups of corporations some of which for example, are, and some of which are not, prevented from filing new elections under the 5-year period, the Secretary of the Treasury is required to issue regulations which provide which group is to be treated as the predominant (or successor group) and hence which group's characteristics are to carry over.

(*c*)(*iv*) *Disallowance of surtax exemption and accumulated earnings credit.*—The bill makes two basic changes to present section 1551. The first change provides that if a corporation transfers property (other than money) directly *or indirectly* to a corporation which it controls, and such transferee corporation was created for the purpose of acquiring such property, or was not actively engaged in business at the time of such acquisition, the Secretary of the Treasury or his delegate may disallow the $25,000 exemption from surtax, or the $100,000 accumulated earnings credit, unless the transferee corpora-

tion establishes by the clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose of the transfer. As presently interpreted, existing law applies only to direct transfers of property other than money. The bill does not affect the transfer of money to a new corporation if the money is not used to indirectly acquire property from the shareholder making the transfer. Therefore, the amendment does not in any way inhibit the organization of new corporations with money transfers even though the corporation is organized for the purpose of acquiring a surtax exemption or accumulated earnings credit. However, the new corporation may be a component member of a controlled group in which case a single surtax exemption is allocated among the members of the group unless the group elects to file a multiple surtax exemption return.

The second change from present law extends the application of section 1551 to transfers of property (other than money) by an individual to a corporation which he and not more than four other individuals control. For purposes of determining whether the transferor is considered to be in control of the transferee corporation, the individual who makes the transfer, together with no more than four other individuals, must own at least 80 percent of the value or voting power of the stock in two or more corporations, one of which is the transferee corporation, and the same individuals must own more than 50 percent of the value or voting power of the stock in each corporation (only taking into account identical stock holdings) after the transfer. In determining ownership of stock, the constructive ownership rules for determining if a controlled group exists are applicable.

In order to prevent both a disallowance of a surtax exemption to a corporation and the imposition of an additional tax on the income of the corporation if it is a member of a controlled group which elects to pay the additional tax, the bill provides that the additional 6 percent tax applicable to groups making such elections will not be applicable to a corporation denied a surtax exemption under section 1551.

(c)(v) *Effective date.*—The amendment with respect to the limitation of the number of surtax exemptions allowable to component members of a controlled group and authority for component members to elect to file multiple surtax exemption returns is effective with respect to taxable years of corporations ending after December 31, 1963. The amendments made to sections 269 and 1551 are effective with respect to transfers made after June 12, 1963.

(d) *Revenue effect.*—It is expected that this provision will increase revenues by about $35 million in a full year of operation.

V. APPENDIX

THE WHITE HOUSE,
Washington, August 19, 1963.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR WILBUR: I want to express my appreciation to you and all other members of the House Ways and Means Committee for your long and constructive labors in formulating a new tax bill. The two-step tax reduction and revision program voted by your committee will provide much needed jobs for our economy, increase our rate of economic growth, promote balance in our international payments, and benefit the individual and corporate taxpayer. It is most important now that the bill be enacted this year as rapidly as possible, so that businessmen whose investment and expansion plans are keyed to this program can be certain that both steps will become fully effective by January 1, 1965.

I also want to take this opportunity to restate my intentions concerning the relationship of the tax program to the Federal budget.

First, our long-range goal remains a balanced budget in a balanced full-employment economy. It is clear that this goal cannot be achieved without a substantial tax reduction and the greater national income it will produce.

Second, tax reduction must also, therefore, be accompanied by the exercise of an even tighter rein on Federal expenditures, limiting outlays to only those expenditures which meet strict criteria of national need.

Third, consistent with these policies, as the tax cut becomes fully effective and the economy climbs toward full employment, a substantial part of the increased tax revenues will be applied toward a reduction in the transitional deficits which accompany the initial cut in tax rates.

Fourth, assuming enactment of the tax program incorporated in your committee's bill with a consequent loss of revenue of $5 billion more in fiscal 1965 than in fiscal 1964, I nevertheless expect—in strict accordance with the above policies, and in the absence of any unforeseen slowdown in the economy or any serious international contingency in the next 5 months—to be able to submit next January a budget for fiscal 1965 involving an estimated deficit of less than the $9.2 billion forecast for fiscal 1964 by the Secretary of the Treasury in your executive sessions last week.

Fifth and finally, any increases in the Federal debt resulting from these transitional budget deficits will be kept proportionately lower than the increase in our gross national product, and thus the real burden of the Federal debt will be steadily reduced.

Meanwhile, we are continuing our increased efforts to improve governmental efficiency, promote economy and prune expenditures.

Civilian employment increases are being held below the increases in workload and numbers served, and compare favorably with the employment increases of State and local governments. Civilian expenditures for fiscal 1963 were reduced nearly $2 billion below the estimates made in January of this year. Civilian agency requests for new obligational authority in the fiscal 1964 budget were reduced by some $6 billions in the executive budgetary process; and I have recommended further cuts in that budget since its submission to the Congress. The notable progress made by the Department of Defense in reducing costs and eliminating waste is typical of the Government-wide effort to improve the efficiency and effectiveness of our operations.

Let me stress once again that the surest way to alter the pattern of deficits which has characterized 7 of the last 10 years is to enact at this session an effective tax reduction program. That program can both increase our national income and tax revenues and at the same time create a climate for the more prudent control of expenditures in the Government as a whole.

In the light of these stated policies and considerations, I see no reason for placing any conditions or contingencies on the effectiveness of the second phase of the tax reduction program. On the other hand, any delay or contingent feature would substantially reduce the effectiveness of the legislation in stimulating the economy, reducing unemployment, and increasing incentives. This in turn could lead to decreases in revenues below expectations and greater deficits than those now projected.

I hope that you will find as strong bipartisan support for this tax reduction program on the House floor as you did in the Ways and Means Committee. Its enactment is urgently needed this year.

Sincerely,

JOHN F. KENNEDY.

740-258 O—64——17

TECHNICAL EXPLANATION OF THE BILL

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TECHNICAL EXPLANATION OF THE BILL

SECTION 1. DECLARATION BY CONGRESS

Section 1 of the bill provides that it is the sense of Congress that the tax reduction provided by the bill, through stimulation of the economy, will, after a brief transitional period, raise (rather than lower) revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. Such section also provides that, to further the objective of obtaining balanced budgets in the near future, Congress by this action recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

SECTION 2. SHORT TITLE, ETC.

(*a*) *Short title.*—Subsection (a) of section 2 of the bill provides that the bill may be cited as the "Revenue Act of 1963".

(*b*) *Amendment of 1954 Code.*—Subsection (b) of section 2 of the bill provides that whenever in the bill an amendment or repeal is expressed in terms of an amendment to or repeal of a section or other provision, the reference is considered to be made to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—REDUCTION OF INCOME TAX RATES AND RELATED AMENDMENTS

PART I—INDIVIDUALS

SECTION 111. REDUCTION OF TAX ON INDIVIDUALS

(*a*) *Individuals other than heads of households.*—Subsection (a) of section 111 of the bill amends section 1(a) of the code by decreasing in two steps the present rates of tax on individuals other than heads of households. Paragraph (1) of section 1(a) of the code, as amended by this section of the bill, contains a table setting forth the reduced rates effective for taxable years beginning on or after January 1, 1964, and before January 1, 1965. Paragraph (2) of section 1(a) of the code, as so amended, contains a table setting forth the reduced rates effective for taxable years beginning after December 31, 1964.

(*b*) *Heads of households.*—Subsection (b) of section 111 of the bill amends paragraph (1) of section 1(b) of the code by decreasing in two steps the present rates of tax on heads of households. Subparagraph (A) of section (1)(b)(1) of the code, as amended by this section of the bill, contains a table setting forth the reduced rates effective for taxable years beginning on or after January 1, 1964, and before January 1, 1965. Subparagraph (B) of section (1)(b)(1)

of the code, as so amended, contains a table setting forth the reduced rates effective for taxable years beginning after December 31, 1964.

SECTION 112. MINIMUM STANDARD DEDUCTION

(*a*) *General rule.*—Subsection (a) of section 112 of the bill amends part IV of subchapter B of chapter 1 of the code (relating to the standard deduction for individuals) by making certain changes in sections 141 and 144. In general these changes will be effective, under part III of title I of the bill, for taxable years beginning after December 31, 1963.

Under existing law, taxpayers electing the standard deduction under section 144 of the code may deduct an amount equal to 10 percent of adjusted gross income or $1,000, whichever is the lesser, except that for a married individual filing a separate return the standard deduction cannot exceed $500.

SECTION 141. STANDARD DEDUCTION

(*a*) *Standard deduction.*—Section 141(a) of the code (as amended by sec. 112(a) of the bill) provides that, except as otherwise provided in section 141, the standard deduction is the larger of the 10-percent standard deduction (defined in sec. 141(b), discussed below) or the minimum standard deduction (defined in sec. 141(c), discussed below). However, the standard deduction (whether it is the 10-percent standard deduction or the minimum standard deduction) may in no event exceed $1,000, or $500 in the case of a separate return by a married individual.

(*b*) *Ten-percent standard deduction.*—Section 141(b) provides that the 10-percent standard deduction is an amount equal to 10 percent of adjusted gross income.

(*c*) *Minimum standard deduction.*—Section 141(c) provides that the minimum standard deduction is the sum of two amounts. Under paragraph (1) of section 141(c) the first amount is determined by multiplying by $100 the number of exemptions allowed the taxpayer as deductions for the taxable year under section 151. Under paragraph (2) of such section the second amount is $200 for a husband and wife filing a joint return of income tax under section 6013, $200 for an unmarried individual, and $100 for a married individual filing a separate return.

(*d*) *Married individuals filing separate returns.*—Section 141(d) provides special rules in the case of married individuals filing separate returns.

Paragraph (1) of section 141(d) provides that notwithstanding section 141(a) the minimum standard deduction does not apply in the case of a married individual filing a separate return if the tax of the other spouse is determined with reference to the 10-percent standard deduction (including the case where the other spouse pays the tax shown in Table IV in sec. 3(a) or Table IV in sec. 3(b) (relating to optional tax if adjusted gross income is less than $5,000)). Thus, even where the minimum standard deduction is larger than the 10-percent standard deduction, the standard deduction of a married individual filing a separate return is the 10-percent standard deduction if his spouse takes the 10-percent standard deduction. In general,

both spouses must take the minimum standard deduction, or neither may take it.

Paragraph (2) of section 141(d) provides that a married individual who files a separate return may elect (under regulations prescribed by the Secretary of the Treasury or his delegate) the minimum standard deduction in lieu of the 10-percent standard deduction, even though the minimum standard deduction of such individual is less than his 10-percent standard deduction, if the minimum standard deduction of his spouse is greater than the spouse's 10-percent standard deduction.

If no election is made by his spouse under paragraph (2), a married individual who is required by the provisions of paragraph (1) to take the 10-percent standard deduction when the minimum standard deduction is larger would pay a higher tax than if the minimum standard deduction applied. However, his spouse could elect the minimum standard deduction although such spouse's 10-percent standard deduction is larger. Generally, such spouse would so elect under paragraph (2) if the total of his tax and his spouse's tax, each determined with regard to the minimum standard deduction, is less than the total of his tax and his spouse's tax, each determined with regard to the 10-percent standard deduction.

SECTION 112. MINIMUM STANDARD DEDUCTION (Continued)

(*b*) *Amendment of section 2.*—Subsection (b) of section 112 of the bill amends section 2(a) of the code (relating to tax in case of joint return or return of surviving spouse).

Under existing law, a return of a surviving spouse, for purposes of sections 2 and 3 of the code, is treated as a joint return of a husband and wife under section 6013. The amendment made by this subsection of the bill extends the treatment of a surviving spouse's return as a joint return to section 141 of the code (relating to standard deduction).

(*c*) *Amendments of section 144.*—Subsection (c) of section 112 of the bill amends section 144 of the code (relating to election of standard deduction). Under the existing section 144, the taxpayer may, after he has filed his return, change his election, under regulations prescribed by the Secretary of the Treasury or his delegate, either to take, or not to take, the standard deduction, or to pay, or not to pay, the tax under section 3 (relating to optional tax if adjusted gross income is less than $5,000). As amended, section 144 of the code allows a taxpayer also to change his election under section 141(d)(2).

Paragraph (1) of section 112(c) amends section 144(b) of the code to permit, under regulations prescribed by the Secretary of the Treasury or his delegate, a change of election with respect to the standard deduction (as defined in sec. 144(c), discussed below) after the filing of the return for such year.

Paragraph (2) of section 112(c) adds a new subsection (c) to section 144 of the code. The new subsection defines the term "change of election with respect to the standard deduction" to mean—

(1) a change of an election to take (or not to take) the standard deduction;

(2) a change of an election to pay (or not to pay) the tax under section 3 (relating to optional tax if adjusted gross income is less than $5,000); or

(3) a change of election under section 141(d)(2) (relating to standard deduction in the case of married individuals filing separate returns).

Thus, a change of election under section 141(d)(2) to have, or not to have, tax determined with regard to the minimum standard deduction is subject to the same rules as a change of election to take, or not to take, the standard deduction or a change of election to pay, or not to pay, the tax under section 3.

(*d*) *Conforming amendments.*—Subsection (d) of section 112 of the bill amends sections 6212(c)(2) and 6504(3) of the code (relating to cross references) to conform to the new language of section 144.

SECTION 113. RELATED AMENDMENTS

(*a*) *Retirement income credit.*—Subsection (a) of section 113 of the bill amends section 37(a) of the code (relating to credit against tax for retirement income) to provide that the rate to be used in computing such credit is 15 percent instead of the rate provided in section 1 of the code for the first $2,000 of taxable income as under existing law.

(*b*) *Tax on nonresident alien individuals.*—Subsection (b) of section 113 of the bill amends section 871(b) of the code (relating to tax on nonresident alien individuals) by changing the $15,400 figure contained therein to $19,000 for a taxable year beginning in 1964, and to $21,200 for taxable years beginning after 1964.

SECTION 114. CROSS REFERENCES TO TAX TABLES, ETC.

Section 114 of the bill contains cross references to the provisions of the bill relating to optional tax if adjusted gross income is less than $5,000 (sec. 301) and income tax collected at source (sec. 302).

Part II—Corporations

SECTION 121. REDUCTION OF TAX ON CORPORATIONS

Subsection (a) of section 121 of the bill amends section 11 of the code (relating to tax on corporations).

Section 11(a) of the code, as amended by this section of the bill, is identical with the existing section 11(a).

Section 11(b) as amended provides that the normal tax for a corporation is 30 percent of the taxable income in the case of a taxable year beginning before January 1, 1964, and is 22 percent in the case of a taxable year beginning after December 31, 1963.

Section 11(c) as amended provides that for a taxable year beginning before January 1, 1964, the surtax for a corporation is equal to 22 percent of the amount by which the taxable income exceeds the surtax exemption; for a taxable year beginning after December 31, 1963, and before January 1, 1965, the surtax is equal to 28 percent of the amount by which the taxable income exceeds the surtax exemption; and for a taxable year beginning after December 31, 1964, the surtax is equal to 26 percent of the amount by which the taxable income exceeds the surtax exemption.

Section 11(d) as amended provides that for purposes of subititle A of the code (relating to income tax) the surtax exemption is $25,000

or the amount determined under section 1561 of the code (relating to surtax exemptions in case of certain controlled corporations), whichever is applicable.

SECTION 122. CURRENT TAX PAYMENTS BY CORPORATIONS

(*a*) *Installment payments of estimated income tax by corporations.*—Subsection (a) of section 122 of the bill amends section 6154 of the code (relating to installment payments of estimated income tax by corporations). Section 6154(a) of the code presently provides that for taxable years ending on or after December 31, 1959, 50 percent of the amount of estimated tax, as defined in section 6016(b) of the code, must be paid. Section 6154(b) of the code presently provides that if the declaration of estimated tax is filed on or before the 15th day of the 9th month of the taxable year, the amount determined under section 6154(a) is to be paid in two equal installments on the 15th day of the 9th and 12th months of the taxable year, and if the declaration is filed after the 15th day of the 9th month, the amount determined under section 6154(a) is to be paid in full on or before the 15th day of the 12th month.

Section 6154(a) of the code, as amended by this section of the bill, combines subsections (a) and (b) of the existing section 6154. The amended section 6154(a) provides that for taxable years beginning in 1964, 52 percent of the amount of estimated tax, as defined in section 6016(b), must be paid. For taxable years beginning in 1965, 1966, 1967, 1968, 1969, and 1970 or a subsequent year, the amount of estimated tax required to be paid for the taxable year is 58 percent, 68 percent, 78 percent, 88 percent, 94 percent, and 100 percent, respectively, of such tax.

Section 6154(a) as amended further provides that—

(1) if the declaration of estimated tax is filed on or before the 15th day of the 4th month of the taxable year, the estimated tax is to be paid in four installments;

(2) if the declaration is filed after the 15th day of the 4th month and not after the 15th day of the 6th month of the taxable year, and is not required by section 6074(a) of the code to be filed on or before the 15th day of such 4th month, the estimated tax is to be paid in three installments;

(3) if the declaration is filed after the 15th day of the 6th month and not after the 15th day of the 9th month of the taxable year, and is not required by section 6074(a) to be filed on or before the 15th day of such 6th month, the estimated tax is to be paid in two installments; and

(4) if the declaration is filed after the 15th day of the 9th month of the taxable year, and is not required by section 6074(a) to be filed on or before the 15th day of such 9th month, the estimated tax is to be paid in one installment.

Paragraphs (1) through (4) of section 6154(a), as amended, provide tables for cases where section 6154(a) requires 4, 3, 2, or 1 installment, respectively. Each table provides, for taxable years beginning in 1964 and subsequent years, the time for payment of the required installments of estimated tax and the percentage of estimated tax required to be paid at such time.

Paragraph (5) of section 6154(a), as amended, provides that if the declaration is filed after the time prescribed in section 6074(a) (determined without regard to any extension of time for filing the declaration under sec. 6081), paragraphs (2), (3), and (4) of section 6154(a) do not apply, and there must be paid at the time of such filing all installments of estimated tax which would have been payable at or before such time if the declaration had been filed within the time prescribed in section 6074(a); and the remaining installments must be paid at the times at which, and in the amounts in which, they would have been payable if the declaration had been so filed. The application of this paragraph is illustrated by the following example: Assume that X corporation, a calendar-year corporation, could reasonably anticipate on January 1, 1964, an estimated tax liability of $20,000 for 1964. Further assume that X did not file its declaration until July 1, 1964. Since X first met the requirements of section 6016 of the code before the first day of the fourth month of the taxable year, it should have filed its declaration on or before April 15, 1964 (in accordance with sec. 6074 of the code, as amended by sec. 112(b) of the bill). Paragraph (1) of section 6154(a), as amended, provides that if the declaration is filed on or before the 15th day of the 4th month of the taxable year, the estimated tax is to be paid in four installments, on the 15th day of the 4th, 6th, 9th, and 12th months of the taxable year. The amounts to be paid on such installment dates are 1, 1, 25, and 25 percent of the estimated tax, respectively. X corporation therefore is required to pay on July 1, 1964, when it files the declaration, the two $200 installments which should have been paid on April 15 and June 15, or a total of $400. X corporation is further required to pay two $5,000 installments, one on September 15, 1964, and one on December 15, 1964.

Amendment of declaration

Section 6154(b) of the code, as amended by this section of the bill, provides that if any amendment of a declaration is filed, the amount of each remaining installment (if any) is the amount which would have been payable if the new estimate had been made when the first estimate for the taxable year was made, increased or decreased (as the case may be) by the amount computed by dividing—

(1) the difference between (A) the amount of estimated tax required to be paid before the date on which the amendment is made, and (B) the amount of estimated tax which would have been required to be paid before such date if the new estimate had been made when the first estimate was made, by

(2) the number of installments remaining to be paid on or after the date on which the amendment is made.

The application of the new section 6154(b) is illustrated by the following example: Assume that Y corporation, a calendar-year corporation, determines that its estimated tax liability for 1964 is $25,000. Further assume that Y properly files its declaration on April 15, 1964, and pays the first two installments of estimated tax on April 15 and June 15 in the amount of $250 each (as required by par. (1) of sec. 6154(a) as amended). On July 1, 1964, Y discovers that its 1964 estimated tax can reasonably be expected to be $50,000. Y should file an amended declaration on or before September 15 showing estimated tax of $50,000, and the installments payable

on September 15 and December 15 should be $12,750 each, computed in the following manner: $50,000×25%=$12,500 (the amount which would have been payable on September 15 and December 15 if the new estimate had been made when the first estimate was made) increased by $250 (the difference between $1,000 (the amount of estimated tax which would have been required to be paid prior to July 1, based on the new estimate) and $500 (the amount of estimated tax required to be paid before the date of the amendment) divided by 2 (the number of installments remaining after the date of the amendment)).

Section 6154(c) (relating to application to short taxable year), and section 6154(d) (relating to installments paid in advance), as amended, are identical with the existing section 6154 (d) and (e).

(*b*) *Time for filing declarations of estimated income tax by corporations.*—Subsection (b) of section 122 of the bill amends section 6074 of the code (relating to time for filing declarations of estimated income tax by corporations).

Section 6074(a) of the code, as amended by this section of the bill, provides that—

(1) if the requirements of section 6016 of the code (relating to declarations of estimated income tax by corporations) are first met before the 1st day of the 4th month of the taxable year, the declaration is to be filed on or before the 15th day of the 4th month of the taxable year;

(2) if the requirements of section 6016 are first met after the last day of the 3d month and before the 1st day of the 6th month of the taxable year, the declaration is to be filed on or before the 15th day of the 6th month of the taxable year;

(3) if the requirements of section 6016 are first met after the last day of the 5th month and before the 1st day of the 9th month of the taxable year, the declaration is to be filed on or before the 15th day of the 9th month of the taxable year; and

(4) if the requirements of section 6016 are first met after the last day of the 8th month and before the 1st day of the 12th month of the taxable year, the declaration is to be filed on or before the 15th day of the 12th month of the taxable year.

The rules in section 6074(a) as amended are presented in tabular form.

Section 6074(b) as amended provides that an amendment of a declaration may be filed in any interval between installment dates prescribed for the taxable year, but only one amendment may be filed in each such interval. The existing section 6074(b) provides that if a declaration is filed before the 15th day of the 12th month of the taxable year, an amendment of such declaration may be filed on or before such day.

Section 6074(c) as amended is identical with the existing section 6074(c).

(*c*) *Failure by corporations to pay estimated income tax.*—Subsection (c) of section 122 of the bill amends the second sentence of section 6655(c)(2) of the code (relating to period of underpayment) to provide that a payment of estimated tax on any installment date is considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under section 6655(b)(1) for such installment date. The second sentence of section 6655(c)(2) presently provides that a payment of estimated

tax on the 15th day of the 12th month is considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under section 6655(b)(1) for the 15th day of the 12th month.

Subsection (c) of section 122 of the bill also amends section 6655(d)(3) of the code (relating to exception) to permit (1) annualization of taxable income for the first 3 months for the purpose of determining whether an addition to the tax is to be made for underpayment of the installment required to be paid on or before the 15th day of the 4th month, and (2) annualization of taxable income for the first 3 months or for the first 5 months for the purpose of determining whether an addition to the tax is to be made for underpayment of the installment required to be paid on or before the 15th day of the 6th month.

(*d*) *Technical amendment.*—Subsection (d) of section 122 of the bill makes a technical amendment to section 6016(f) (relating to declarations of estimated income tax by corporations).

SECTION 123. RELATED AMENDMENTS

(*a*) *Tax on mutual insurance companies (other than life, etc.).*—Subsection (a)(1) of section 123 of the bill amends section 821(a) of the code (relating to imposition of tax) to provide that for each taxable year beginning after December 31, 1963, the normal tax on mutual insurance company taxable income is 22 percent of such income, or 44 percent of the amount by which such income exceeds $6,000, whichever is the lesser. Subsection (a)(1) of section 123 further amends section 821(a) to provide that there is imposed on mutual insurance company taxable income a surtax computed as provided in section 11(c) of the code and as though the mutual insurance company taxable income were the taxable income referred to in section 11(c). Thus the surtax rate on mutual insurance company taxable income in excess of $25,000 is 28 percent for a taxable year beginning after December 31, 1963, and before January 1, 1965, and is 26 percent for a taxable year beginning after December 31, 1964.

Subsection (a)(2) of section 123 of the bill amends section 821(c)(1) of the code (relating to alternative tax for certain small companies) to provide that for each taxable year beginning after December 31, 1963, the normal tax on taxable investment income is 22 percent of such income, or 44 percent of the amount by which such income exceeds $3,000, whichever is the lesser. Subsection (a)(2) of section 123 further amends section 821(c)(1) to provide that there is imposed on taxable investment income a surtax computed as provided in section 11(c) of the code and as though the taxable investment income were the taxable income referred to in section 11(c). Thus the surtax rate on taxable investment income in excess of $25,000 is 28 percent for a taxable year beginning after December 31, 1963, and before January 1, 1965, and is 26 percent for a taxable year beginning after December 31, 1964.

(*b*) *Receipt of minimum distributions by domestic corporations.*—Subsection (b) of section 123 of the bill amends section 963(b) of the code (relating to receipt of minimum distributions by domestic corporations) to provide a new minimum distribution table for taxable years beginning in 1964, and a new minimum distribution table for taxable years beginning after December 31, 1964. The application of

the existing minimum distribution table is limited to taxable years beginning in 1963.

(c) *Amendment of section 242.*—Subsection (c) of section 123 of the bill amends section 242(a) of the code (relating to deduction for partially tax-exempt interest) to provide that the deduction allowed by the first sentence of section 242(a) is not allowed for the purpose of any surtax imposed by subtitle A of the code (relating to income taxes).

Part III—Effective Dates

SECTION 131. GENERAL RULE

Section 131 of the bill provides that, except for purposes of section 21 of the code (relating to effect of changes in rates during a taxable year), the amendments made by parts I and II of title I of the bill apply with respect to taxable years beginning after December 31, 1963.

SECTION 132. FISCAL YEAR TAXPAYERS

Section 132 of the bill amends section 21 of the code (relating to effect of changes in rates during a taxable year). Section 21 presently provides (in subsec. (a)) the general rule that if the effective date of the change of a rate of tax falls on a date other than the first day of a taxable year, then tentative taxes are computed by applying the rate for the period before the effective date, and the rate for the period on and after such date, to the taxable income for the entire taxable year. The tax for such taxable year is the sum of that proportion of each tentative tax which the number of days in each period bears to the number of days in the entire taxable year.

Under this section of the bill, subsection (d) of the existing section 21 of the code (relating to a taxable year beginning before January 1, 1954, and ending after December 31, 1953) is replaced with a new subsection (d) (relating to changes made by Revenue Act of 1963).

Paragraph (1) of the new section 21(d) provides certain rules for applying section 21(a) to the taxable year of an individual beginning in 1963 and ending in 1964 or beginning in 1964 and ending in 1965. These rules deal with the effect of part IV of subchapter B of chapter 1 of the code (relating to standard deduction for individuals) and sections 3 and 4 of the code (relating to optional tax if adjusted gross income is less than $5,000 and to rules for optional tax, respectively). Subparagraph (A) of paragraph (1) provides that, in making the computation of tentative tax under section 21(a) using the tax rate for the period on and after January 1, 1964, such rate is applied to the taxable income determined as if part IV of subchapter B (as amended by the bill) applied to taxable years ending after December 31, 1963. Subparagraph (B) of paragraph (1) provides that, in applying section 21(a) to the taxable year of an individual beginning in 1963 and ending in 1964, section 4 of the code (relating to rules for optional tax), as amended by the bill, applies to taxable years ending after December 31, 1963. Paragraph (1) of the new section 21(d) further provides that, in applying section 21(a) to a taxable year of an individual beginning in 1963 and ending in 1964, or beginning in 1964 and ending in 1965, the change in the tax imposed under section 3 of

the code (relating to optional tax if adjusted gross income is less than $5,000) is treated as a change in a rate of tax.

The application of paragraph (1) of the new section 21(d) is illustrated by the following examples:

Example (1).—Assume that A and his wife have four children and have a taxable year beginning July 1, 1963, and ending June 30, 1964. Further assume that their adjusted gross income for the taxable year is $7,000 and that they file a joint return.

Their tentative tax computed by using the rate for the period before the effective date of the change in rate is determined with respect to taxable income computed as follows:

$7, 000 adjusted gross income
—3, 600 personal exemptions
—700 standard deduction (10 percent of adjusted gross income)

$2, 700 taxable income

Their tentative tax computed by using the rate for the period on and after the effective date of the change in rate is determined with respect to taxable income computed as follows:

$7, 000 adjusted gross income
—3, 600 personal exemptions
—800 minimum standard deduction

$2, 600 taxable income

Example (2).—Assume that B and his wife have three children and have adjusted gross income of $4,000, and elect to pay the tax imposed by section 3 of the code (relating to optional tax). Further assume that their taxable year begins July 1, 1964, and ends June 30, 1965, and that they file a joint return. Their tentative tax computation with respect to the rate for the period before the effective date of the change in rate is made by using the tax table applicable to the earlier of the two calendar years in which their fiscal year falls. Thus, their tentative tax for such period (using Table III of subsec. (a) of sec. 3) is $52. Their tentative tax computation with respect to the rate for the period after the effective date of the change of rate is made by using the tax table applicable to the later of the two calendar years in which their fiscal year falls. Thus, their tentative tax for such period (using Table III of subsec. (b) of sec. 3) is $46. Their tax for the taxable year is the sum of $\frac{184}{365} \times \$52$ ($25.76) and $\frac{181}{365} \times \$46$ ($23.53), which equals $49.29.

Paragraph (2) of the new section 21(d) provides certain rules for applying section 21(a) for the purpose of computing the tax liability of a corporation which is subject to the provisions of part II of subchapter B of chapter 6 of the code (relating to certain controlled corporations), as added by section 223(a) of the bill, for a taxable year beginning in 1963 and ending in 1964. Paragraph (2) provides that if—

(A) the surtax exemption (as defined in sec. 11(d) of the code, as amended by sec. 121 of the bill) of such corporation for such taxable year is less than $25,000 by reason of the application of

section 1561 of the code (relating to surtax exemptions in case of certain controlled corporations), as added by section 223(a) of the bill, or

(B) an additional tax is imposed under section 1562(b) of the code (as added by sec. 223(a) of the bill) on the taxable income of such corporation for such taxable year,

then the change in the surtax exemption or the imposition of such additional tax is treated as a change in rate of tax taking effect on January 1, 1964. The application of paragraph (2) of section 21(d) is illustrated by the following examples:

Example (1).—The surtax exemption of corporation X, which files its income tax returns on the basis of a fiscal year ending March 31, is, for its taxable year ending March 31, 1964, less than $25,000 by reason of the application of section 1561 of the code (as added by sec. 223(a) of the bill). The taxable income of corporation X is $100,000 and the amount of the surtax exemption determined under section 1561 for such taxable year is $5,000. Corporation X's income tax liability for the taxable year ending March 31, 1964, is computed under section 21 as follows:

First tentative tax

Taxable income	$100, 000
Normal tax on $100,000 (using 1963 rates), 30 percent of $100,000	30, 000
Surtax on $75,000 (using 1963 rates and a $25,000 surtax exemption), 22 percent of $75,000	16, 500
Total tentative tax at rates and surtax exemption effective before Jan. 1, 1964	$46, 500

Second tentative tax

Taxable income	$100, 000
Normal tax on $100,000 (using 1964 rates), 22 percent of $100,000	22, 000
Surtax on $95,000 (using 1964 rates and a $5,000 surtax exemption), 28 percent of $95,000	26, 600
Total tentative tax at rates and surtax exemption effective after Jan. 1, 1964	$48, 600

The tentative taxes are apportioned as follows:

275/366 of $46,500 (the first tentative tax)	$34, 925
91/366 of $48,600 (the second tentative tax)	12, 103
Total tax for the taxable year	$47, 028

Example (2).—Corporation Z, which files its income tax returns on the basis of a fiscal year ending June 30, is, for its taxable year ending June 30, 1964, subject to the additional tax imposed by section 1562(b) of the code. The taxable income of corporation Z is $100,000. Corporation Z's income tax liability for the taxable year ending June 30, 1964, is computed under section 21 as follows:

First tentative tax

Taxable income	$100, 000
Normal tax on $100,000 (using 1963 rates), 30 percent of $100,000	30, 000
Surtax on $75,000 (using 1963 rates and a $25,000 surtax exemption), 22 percent of $75,000	16, 500
Total tentative tax at rates and surtax exemption effective before Jan. 1, 1964	$46, 500

Second tentative tax

Taxable income	$100,000
Normal tax on $100,000 (using 1964 rates), 22 percent of $100,000	22,000
Surtax on $75,000 (using 1964 rates and a $25,000 surtax exemption), 28 percent of $75,000	21,000
Additional tax under sec. 1562(b), 6 percent of 1st $25,000 of taxable income	1,500
Total tentative tax at rates effective after Jan. 1, 1964	$44,500

The tentative taxes are apportioned as follows:

184/366 of $46,500 (the first tentative tax)	$23,368
182/366 of $44,500 (the second tentative tax)	22,204
Total tax for the taxable year	$45,572

TITLE II—STRUCTURAL CHANGES

SECTION 201. DIVIDENDS RECEIVED BY INDIVIDUALS

In general, section 201 of the bill amends section 34 of the code to reduce the credit for dividends received by individuals from 4 to 2 percent for dividends received in the calendar year 1964, and repeals section 34 for dividends received thereafter. Section 201 of the bill also amends section 116 of the code to increase the partial exclusion of dividends received by individuals from $50 to $100 for taxable years beginning after December 31, 1963.

(*a*) *Reduction of 4 percent credit to 2 percent credit for calendar year 1964.*—Subsection (a) of section 201 of the bill amends section 34 of the code (relating to credit for dividends received by individuals). Under existing law, section 34(a) of the code (subject to the provisions of subsecs. (c), (d), and (e) of sec. 34) allows an individual, as a credit against his tax, an amount equal to 4 percent of the dividends received from domestic corporations and included in gross income for the taxable year. Section 34(b) provides, however, that such credit cannot exceed the lesser of the tax itself (reduced by the foreign tax credit allowable under sec. 33) or 4 percent of taxable income.

General rule

Paragraph (1) of section 34(a) of the code, as amended by subsection (a)(1) of section 201 of the bill, provides that the existing 4-percent credit will be allowed with respect to dividends received before January 1, 1964. Paragraph (2) of section 34(a) as so amended provides that a 2-percent credit will be allowed with respect to dividends received during the calendar year 1964. The credit in all cases is determined with reference to the date on which the dividends are received, regardless of the taxable year of the individual receiving them.

Limitations

Section 34(b) of the code limits the credit allowed an individual to the lesser of the amounts referred to in paragraphs (1) and (2) of such section. The existing paragraph (1) (which limits the credit by reference to the amount of tax imposed for the taxable year) is retained without change, but paragraph (2) (which limits the credit by reference to a percentage of taxable income for the taxable year) is amended. Subparagraph (A) of paragraph (2) as amended provides that the percentage limitation is 2 percent of taxable income in the case of a taxable year beginning after December 31, 1963; and sub-

paragraph (B) of paragraph (2) as amended provides that such limitation is 4 percent of taxable income for taxable years beginning before January 1, 1964.

(*b*) *Repeal of credit for dividends received by individuals.*—Subsection (b) of section 201 of the bill repeals section 34 of the code, effective with respect to dividends received after December 31, 1964.

(*c*) *Doubling of amount of partial exclusion from gross income of dividends received by individuals.*—Subsection (c) of section 201 of the bill amends section 116 of the code (relating to partial exclusion from gross income of dividends received by individuals). Under existing law, section 116(a) allows a taxpayer to exclude from gross income the first $50 of dividends received from domestic corporations in a taxable year. In the case of a joint return of a husband and wife, each spouse is entitled to the exclusion (in an amount not in excess of $50) with respect to the dividends received by such spouse.

Section 116(a) of the code, as amended by this section of the bill, provides for the increase of this exclusion to $100 for each individual, and retains the provision of existing law that such exclusion applies to the dividends first received in the taxable year. Thus, in the case of a joint return of a husband and wife, each spouse is entitled to the exclusion (in an amount not in excess of $100) with respect to the dividends received by such spouse. This provision is effective (under subsec. (e) of sec. 201 of the bill) with respect to taxable years beginning after December 31, 1963.

(*d*) *Conforming amendments.*—Subsection (d) of section 201 of the bill amends the table of sections for subpart A of part IV of subchapter A of chapter 1 of the code by striking out the reference to section 34, and amends sections 35, 37, 46, 584, 702, 854, 857, 871, 1375, and 6014 of the code by striking out any reference to section 34 appearing therein.

In addition, paragraph (6)(A) of subsection (d) amends section 642(a) of the code by striking out paragraph (3), which provides the rule that, for purposes of determining the time of receipt of dividends under sections 34 and 116, dividends received by an estate or trust which are properly allocable to a beneficiary under section 652 or 662 shall be deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust. However, the deleted rule remains applicable for purposes of determining the time of receipt of dividends under section 116; paragraph (6)(C) of subsection (d) adds the applicable portion of the deleted rule as a new paragraph (3) in section 116(a), and paragraph (6)(B) adds to section 642(i) a cross-reference to this rule.

(*e*) *Effective dates.*—Subsection (e) of section 201 of the bill provides that the amendments made by subsection (a) apply with respect to taxable years ending after December 31, 1963; subsection (b) applies with respect to taxable years ending after December 31, 1964; the amendment made by subsection (c) apply with respect to taxable years beginning after December 31, 1963; and the amendments made by subsection (d) apply with respect to dividends received after December 31, 1964, in taxable years ending after such date. Thus the special rule of section 642(a)(3) of the code remains effective for purposes of section 34 for dividends received by an estate or trust before January 1, 1965.

SECTION 202. REPEAL OF REQUIREMENT THAT BASIS OF SECTION 38 PROPERTY BE REDUCED BY 7 PERCENT; OTHER PROVISIONS RELATING TO INVESTMENT CREDIT

(*a*) *Repeal of requirement that basis be reduced.*—Subsection (a) of section 202 of the bill repeals section 48(g) of the code, which relates to adjustments to basis of section 38 property (that is, property with respect to which an investment credit is allowable), with respect to such property placed in service after June 30, 1963. In the case of property placed in service before July 1, 1963, subsection (a) of section 202 of the bill repeals section 48(g) with respect to taxable years beginning after June 30, 1963, and provides for an increase in basis as of the first day of the taxpayer's first taxable year which begins after June 30, 1963. Subsection (a) of section 202 also makes certain related amendments to the code.

Repeal of reduction in basis under section 48(g)(1)

Paragraph (1) of section 202(a) of the bill repeals paragraph (1) of section 48(g) of the code. (See below for discussion of repeal of paragraph (2) of section 48(g).) Under paragraph (1) of section 48(g), the basis of any section 38 property is reduced by an amount equal to 7 percent of the qualified investment (as determined under section 46(c)) with respect to such property. This reduction in basis is taken into account for purposes of subtitle A of the code, relating to income tax, except for purposes of computing, or recomputing, the investment credit. Thus, the reduction in basis is taken into account for purposes of computing depreciation deductions and for purposes of computing gain or loss on the sale or other disposition of the property.

This repeal is effective (under paragraph (4) of section 202(a) of the bill), in the case of section 38 property placed in service after June 30, 1963, with respect to taxable years ending after June 30, 1963; and in the case of property placed in service before July 1, 1963, with respect to taxable years beginning after June 30, 1963. Thus, a calendar-year taxpayer must reduce the basis of any section 38 property placed in service before July 1, 1963, but is not required to reduce the basis of any section 38 property placed in service after June 30, 1963. No reduction in basis is to be made in the case of section 38 property the construction, reconstruction, or erection of which is completed, or which is acquired, before July 1, 1963, but which is placed in service after June 30, 1963.

Repeal of increase in basis under section 48(g)(2)

Paragraph (1) of section 202(a) of the bill also repeals paragraph (2) of section 48(g) of the code. Under paragraph (2) of section 48 (g), if the tax under chapter 1 of the code is increased for any taxable year under paragraph (1) or (2) of section 47(a) of the code (relating to certain dispositions, etc., of section 38 property) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in such paragraph (1) or (2) of section 47(a) is increased by an amount equal to the portion of such increase in tax, or the portion of such adjustment to carrybacks or carryovers, attributable to such property. The increase in basis is

made immediately before the event which causes paragraph (1) or (2) of section 47(a) to apply. Thus, the increase in basis is taken into account for purposes of determining gain or loss on a disposition of the property.

This repeal is effective (under paragraph (4) of section 202(a) of the bill), in the case of section 38 property placed in service after June 30, 1963, with respect to taxable years ending after June 30, 1963; and in the case of property placed in service before July 1, 1963, with respect to taxable years beginning after June 30, 1963. Thus if, in December 1963, section 47(a) (1) or (2) applies to increase the tax of a calendar year taxpayer under chapter 1 of the code with respect to property placed in service in 1962, the basis of such property is increased under section 48(g)(2) by the amount of such increase in tax.

Increase in basis of property on account of prior reduction

Paragraph (2)(A) of section 202(a) of the bill provides, in general, that the basis of any section 38 property (as defined in section 48(a) of the code) placed in service before July 1, 1963, is to be increased, under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property. In determining the amount of such increase in basis, any prior increase in basis with respect to the property under section 48(g)(2) (in taxable years beginning before July 1, 1963) is to be taken into account. Thus, the amount of the increase in basis under paragraph (2)(A) of section 202(a) of the bill is equal to the amount of the reduction in basis under section 48(g)(1) less any increase in basis under section 48(g)(2) with respect to such property. The basis of any section 38 property is not increased under paragraph (2)(A) of section 202(a) of the bill if the taxpayer dies in a taxable year beginning before July 1, 1963.

The increase in basis provided by paragraph (2)(A) of section 202(a) of the bill is to be made, under paragraph (2)(C) of section 202(a), as of the first day of the first taxable year of the taxpayer which begins after June 30, 1963. Generally, such increase in basis is to be taken into account by the person whose basis of the property was reduced under section 48(g)(1). Thus, in the case of partnership section 38 property, the increase in basis is to be taken into account by the partnership as of the first day of its first taxable year which begins after June 30, 1963. If a transaction to which section 381(a) of the code applies or a mere change in the form of conducting a trade or business (within the meaning of section 47(b) of the code) occurs before the increase in basis has been taken into account by the transferor, the increase in basis is taken into account by the transferee. For example, if calendar-year individual A, who placed section 38 property in service before July 1, 1963, transfers the section 38 property to calendar-year corporation X on September 1, 1963, in a transaction to which section 47(a) does not apply because such transaction constitutes a mere change in the form of conducting the trade or business, the increase in basis is to be taken into account by corporation X as of January 1, 1964.

The increase in basis is to be taken into account for purposes of computing depreciation deductions for the taxpayer's first taxable year which begins after June 30, 1963, and for all subsequent periods,

and for purposes of computing gain or loss on the sale or other disposition of the property.

The provisions of paragraph (2)(A) of section 202(a) of the bill are illustrated by the following example:

Example.—X corporation, which makes its returns on the basis of the calendar year, acquires and places in service on January 1, 1962, an item of new section 38 property with a basis of $10,000 and an estimated useful life of 10 years. For the taxable year 1962, X is allowed a credit of $700 (7 percent of $10,000). Under section 48(g)(1) of the code, the basis of the property is reduced by $700. Under paragraph (2)(A) of section 202(a) of the bill, the basis of the property is increased on January 1, 1964, by $700 (7 percent of $10,000, the qualified investment). However, if such property had been sold by X on December 1, 1963, on such date the basis of such property is increased under section 48(g)(2) by $700, and there would be no further increase on January 1, 1964. If X was a partnership and if a partner had disposed of his partnership interest on December 1, 1963, and on such date the basis of such property had been increased under section 48(g)(2) by $500, the basis of the property would be increased on January 1, 1964, by only $200 ($700 minus $500). If X was an individual who died on December 1, 1963, there would be no increase under section 202(a)(2)(A) of the bill in the basis of such property.

Increase in rental deductions

Paragraph (2)(B) of section 202(a) of the bill provides that if, with respect to any section 38 property placed in service before July 1, 1963, a lessor made the election (provided by sec. 48(d) of the code) to treat the lessee as having purchased such property for purposes of the investment credit, the basis of such property is not to be increased under paragraph (2)(A) of section 202(a) of the bill. However, under regulations prescribed by the Secretary of the Treasury or his delegate, the deductions otherwise allowable under section 162 of the code to the lessee with respect to such property for amounts paid to the lessor under the lease (hereinafter referred to as rental deductions) are to be adjusted in a manner consistent with paragraph (2)(A). The amount of the increase in rental deductions with respect to a leased property placed in service before July 1, 1963, may not exceed the sum of the actual decreases made (under the last sentence of sec. 48(d)) in the rental deductions with respect to such property. In determining the amount of the increase in such rental deductions, any prior increase in such deductions under the last sentence of section 48(d) because of the application of section 47(a) (in taxable years beginning before July 1, 1963) is to be taken into account. The rental deductions with respect to any section 38 property are not to be increased under paragraph (2)(B) of section 202(a) of the bill if the lessee dies in a taxable year beginning before July 1, 1963.

The amount of the increase in rental deductions with respect to a leased property is to be taken into account, commencing with the first taxable year beginning after June 30, 1963, over the remaining portion of the useful life used in making the decreases in rental deductions with respect to such property. Generally, if the lessee terminates the lease during this period, the portion of the increase which has not yet been taken into account is allowed as a deduction in the taxable year in which such termination occurs. If the lessee

actually purchases the leased property during this period, the portion of the increase which has not yet been taken into account is added to the basis of the property at the date of purchase.

If a lessor of property makes the election under section 48(d) to treat the lessee as having purchased section 38 property for purposes of the investment credit and if such lessee in a taxable year beginning before July 1, 1963, actually purchases such property, the basis of such property is increased by 7 percent of the qualified investment with respect to such property (in a manner consistent with par. (2)(A) of sec. 202(a) of the bill) as of the first day of the first taxable year beginning after June 30, 1963.

The provisions of paragraph (2)(B) of section 202(a) of the bill are illustrated by the following example:

Example.—X corporation constructs a machine after December 31, 1961, and on February 1, 1962, leases the machine to Y, a calendar-year taxpayer, who places it in service. The fair market value of the machine on the date on which possession is transferred to Y is $25,200 and the machine has an estimated useful life to X of 12 years. X elects to treat Y as the purchaser of the property for purposes of the investment credit. For purposes of computing qualified investment under section 46(c) of the code, the basis of the property to Y is $25,200 and Y's credit earned for 1962 with respect to such machine is $1,764 (7 percent of $25,200). Y's rental deductions with respect to such machine are decreased by $12.25 each month ($1,764 divided by 144 months). Under paragraph (2)(B) of section 202(a) of the bill, Y's rental deductions are increased by $281.75 ($12.25 multiplied by 23 months). Such increase is taken into account over the remaining 121 months of the useful life of the machine commencing with the taxable year 1964. If Y had actually purchased the machine from X on January 1, 1963, and had reduced the basis of the machine on such date by $1,629.25 ($1,764 minus $134.75), the basis of such machine in Y's hands would be increased, on January 1, 1964, by $1,764 (7 percent of the qualified investment).

Certain leased property

Paragraph (3)(A) of section 202(a) of the bill repeals the last sentence of section 48(d) of the code. Under the last sentence of section 48(d), if a lessor makes an election to treat the lessee of section 38 property as having acquired such property for purposes of the investment credit, section 48(g) (relating to adjustments to basis) does not apply with respect to such property and the deductions otherwise allowable to the lessee under section 162 of the code for amounts paid to the lessor under the lease must be adjusted in a manner consistent with the provisions of section 48(g).

This repeal is effective (under par. (4) of sec. 202(a) of the bill), in the case of section 38 property placed in service after June 30, 1963, with respect to taxable years ending after June 30, 1963; and in the case of property placed in service before July 1, 1963, with respect to taxable years beginning after June 30, 1963. Thus, if lessor X elects to treat calendar year lessee Y, who placed section 38 property in service in July 1962, as the purchaser of the property for purposes of the investment credit, Y reduces his deductions for rental payments under section 162 of the code for his 1962 and 1963 taxable years, but does not reduce his rental deductions for any subsequent taxable

year. If in December 1963 section 47(a) (1) or (2) of the code applies to increase Y's tax with respect to such property, Y's rental deductions with respect thereto are adjusted, under the last sentence of section 48(d), in a manner consistent with section 48(g)(2). However, if Y had placed the property in service in July 1963, Y would not reduce or otherwise adjust his deductions for rental payments for any taxable year.

Deduction for certain unused investment credit

Paragraph (3)(B) of section 202(a) of the bill repeals section 181 of the code. Under section 181, if the amount of the credit earned for any taxable year exceeds the limitation provided by section 46(a)(2) (relating to limitation based on amount of tax) for such year and if any portion of such excess is not allowed as a credit after the application of the 3-year carryback and the 5-year carryover provisions, then the portion of such excess not so allowed as a credit in any of such taxable years is allowed to the taxpayer as a deduction in the sixth taxable year following the taxable year in which the credit was earned. Section 181 further provides that if a taxpayer dies or ceases to exist prior to such sixth taxable year, such taxpayer is allowed as a deduction, for the taxable year of such death or cessation, an amount equal to the proper portion of such excess.

This repeal is effective (under par. (4) of sec. 202(a) of the bill), in the case of section 38 property placed in service after June 30, 1963, with respect to taxable years ending after June 30, 1963; and in the case of property placed in service before July 1, 1963, with respect to taxable years beginning after June 30, 1963.

Adjustments to basis under section 1016

Paragraph (3)(C) of section 202(a) of the bill makes a technical amendment to section 1016(a)(19) of the code (relating to adjustments to basis).

Clerical amendment

Paragraph (3)(D) of section 202(a) of the bill amends the table of sections for part VI of subchapter B of chapter 1 of the code.

Effective date

Paragraph (4) of section 202(a) of the bill provides effective dates for the amendments made by paragraphs (1) and (3) of section 202(a). Paragraph (4)(A) provides that if the property involved is placed in service after June 30, 1963, then the amendments made by paragraphs (1) and (3) apply with respect to taxable years ending after June 30, 1963. Paragraph (4)(B) provides that if the property is placed in service before July 1, 1963, then the amendments made by paragraphs (1) and (3) apply with respect to taxable years beginning after June 30, 1963.

(*b*) *Basis of certain leased property to lessee*.—Subsection (b) of section 202 of the bill amends paragraphs (1) and (2) of section 48(d) of the code, which relate to the basis of property to a lessee. Under the existing section 48(d) (relating to certain leased property), if a lessor elects to treat a lessee as having purchased section 38 property for purposes of the investment credit, the basis of the property to the lessee for the purpose of computing his qualified investment is deemed to be equal to the fair market value of the property if such

property is constructed by the lessor or constructed by a corporation which controls or is controlled by the lessor within the meaning of section 368(c) of the code. In any other case the basis to the lessee is deemed to be the basis of the property in the hands of the lessor.

Paragraph (1) of section 48(d) of the code, as amended by this section of the bill, provides the general rule that the basis of property to the lessee is deemed to be equal to the fair market value of the property. The fair market value is to be determined on the date possession of the property is transferred from the lessor to the lessee.

Paragraph (2) of section 48(d) of the code, as amended by this section of the bill, provides an exception to the general rule if section 38 property is leased by a corporation which is a member of an affiliated group (within the meaning of sec. 46(a)(5) of the code) to another corporation which is a member of the same affiliated group. In such case, the basis of such property to the lessee is deemed to be the basis of the property in the hands of the lessor.

The amendment made by subsection (b) of section 202 of the bill applies, under paragraph (1) of section 202(f), with respect to property possession of which is transferred to a lessee on or after the date of enactment of the bill.

(c) *Treatment of elevators and escalators for purposes of the investment credit.*—Subsection (c) of section 202 of the bill amends paragraph (1) of section 48(a) of the code, which relates to the definition of section 38 property, by adding at the end thereof a new subparagraph (C). The new subparagraph (C) provides that the term "section 38 property" includes elevators and escalators, but only if (i) the construction, reconstruction, or erection of the elevator or escalator involved is completed by the taxpayer after June 30, 1963, or (ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date. For purposes of section 48, the term "elevator" means a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and functionally related equipment which is essential to its operation. Such term includes, for example, guide rails and cables, motors and controllers, control panels and landing buttons, and elevator gates and doors, which are essential to the operation of the elevator. The term "elevator" does not, however, include a structure which is considered a building for purposes of the investment credit. For purposes of section 48, the term "escalator" means a moving staircase and functionally related equipment which is essential to its operation.

For purposes of determining qualified investment under section 46(c) of the code, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of constructing a shaft or of making alterations to the floor, walls, or ceiling, even though such alterations may be necessary in order to install or modernize the elevator or escalator.

The principles applicable under section 48(b) (1) and (2) of the code (relating to new section 38 property) are to be applied under section 48(a)(1)(C) (i) and (ii) of the code (as added by this section of the bill) in determining when an elevator or escalator is acquired by the taxpayer and whether the original use of such elevator or escalator commences with the taxpayer, or when the construction, reconstruction, or erection of an elevator or escalator is completed.

If the construction of an elevator or escalator commences after December 31, 1961, and is completed after June 30, 1963, the entire basis of such elevator or escalator is taken into account in determining qualified investment under section 46(c). However, if construction of the elevator or escalator commences before January 1, 1962, and is completed after June 30, 1963, under the existing section 48(b) only that portion of the basis of such elevator or escalator which is properly attributable to construction after December 31, 1961, is to be taken into account in computing qualified investment. Moreover, the new subparagraph (C) of section 48(a)(1) of the code is limited by other provisions of the investment credit. Thus, an elevator or escalator which satisfies the conditions of section 48(a)(1) is subject to the limitations contained in paragraphs (2) through (5) of section 48(a), relating respectively to property used outside the United States, for lodging, by certain tax-exempt organizations, and by governmental units.

An elevator or escalator may qualify as section 38 property whether it is installed in a new building or in an old building. Also, if an elevator or escalator is reconstructed by the taxpayer after June 30, 1963, the portion of the basis attributable to such reconstruction may be taken into account in computing qualified investment.

The amendments made by subsection (c) of section 202 of the bill apply, under paragraph (2) of section 202(f), with respect to taxable years ending after June 30, 1963.

(*d*) *Treatment of elevators and escalators for purposes of section 1245.*—Subsection (d) of section 202 of the bill amends section 1245(a) of the code, which relates to the general rule for gain from dispositions of certain depreciable property, by revising the first sentence of paragraph (2) and by adding at the end of paragraph (3) a new subparagraph (C).

Recomputed basis

Paragraph (1) of section 202(d) of the bill amends the first sentence of section 1245(a)(2) of the code, which presently provides that, for purposes of section 1245, the term "recomputed basis" means (with respect to any property) its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961, reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168 of the code.

Section 1245(a)(2) of the code, as amended by this section of the bill, provides separate definitions of the term "recomputed basis" for property referred to in paragraph (3) (A) or (B) of section 1245(a) (that is, personal property or certain other property not including a building or its structural components) and for property referred to in paragraph (3)(C) of such section (that is, an elevator or an escalator). In the case of property referred to in paragraph (3) (A) or (B), the existing provisions relating to periods for which adjustments are to be added to adjusted basis are placed in a new subparagraph (A) of section 1245(a)(2). In the case of property referred to in paragraph (3)(C), a new subparagraph (B) of section 1245(a)(2) provides that adjustments are to be added which are attributable to periods after June 30, 1963.

Section 1245 property

Paragraphs (2) and (3) of section 202(d) of the bill add a new subparagraph (C) to section 1245(a)(3) to include an elevator or an escalator within the definition of the term "section 1245 property". Section 1245(a)(3) of the code presently defines such term as any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 of the code and is either (A) personal property, or (B) certain other property (not including a building or its structural components).

The amendments made by section 202(d) of the bill apply, under paragraph (3) of section 202(f), with respect to dispositions of elevators or escalators after December 31, 1963, in taxable years ending after such date.

(*e*) *Treatment of investment credit by Federal regulatory agencies.*—Subsection (e) of section 202 of the bill states that it was the intent of the Congress in providing an investment credit under section 38 of the code, and it is the intent of the Congress in repealing the adjustments to basis required by section 48(g), to provide an incentive for modernization and growth of private industry (including that portion thereof which is regulated). Subsection (e) of section 202 further provides that Congress does not intend that any agency or instrumentality of the United States having jurisdiction with respect to a taxpayer shall, without the consent of the taxpayer, use (1) in the case of public utility property (as defined in sec. 46(c)(3)(B) of the code), more than a proportionate part (determined with reference to the average useful life of the property with respect to which the credit was allowed) of the credit against tax allowed by section 38 for any taxable year, or (2) in the case of any other property, any credit against tax allowed by section 38, to reduce such taxpayer's Federal income taxes for the purpose of establishing the cost of service of the taxpayer or to accomplish a similar result by any other method.

(*f*) *Effective dates.*—Subsection (f) of section 202 of the bill sets forth the effective dates for the amendments made by subsections (b), (c), and (d) of such section. These effective dates are specifically dealt with in the discussion (above) of the provisions to which they respectively relate.

SECTION 203. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *Inclusion in income.*—Subsection (a)(1) of section 203 of the bill adds a new section 79 to part II of subchapter B of chapter 1 of the code (relating to items specifically included in gross income).

SECTION 79. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *General rule.*—Under existing Treasury regulations and rulings of the Internal Revenue Service, an employee is not required to include in gross income the current value of group-term life insurance purchased for him by his employer. The new section 79(a) provides the general rule that there is included in an employee's gross income for his taxable year an amount equal to the cost of group-term life insurance on his life provided for part or all of such taxable year under a policy (or policies) carried directly or indirectly by his em-

ployer (or employers); but only to the extent that such cost exceeds the sum of (1) the cost of $30,000 of such insurance and (2) the amount (if any) paid by the employee toward the purchase of such insurance. The new section 79 does not affect the tax treatment of other types of insurance (such as group permanent life insurance) provided for employees by their employers, or the tax treatment of group-term life insurance provided for individuals (such as independent contractors and partners) who are not employees.

More than one employer

In determining the amount of group-term life insurance provided on his life during the taxable year, an employee must take into account all such insurance furnished directly or indirectly by all of his employers. For example, if an employee receives $25,000 of group-term life insurance during an entire taxable year under a policy carried by employer A and also receives $15,000 of group-term life insurance during the same taxable year under a policy carried by employer B, the employee is required to include in gross income the cost of $10,000 of insurance for so much of the taxable year as he had this dual coverage.

Application of exclusions

In determining the amount includible in an employee's income with respect to group-term life insurance provided for part or all of a taxable year, the cost of such insurance is reduced by the following two amounts:

(1) the cost of so much of such insurance as does not exceed $30,000 of protection, and

(2) the amount (if any) paid by the employee toward the purchase of such insurance.

Insurance provided for part of a taxable year

The $30,000 of insurance referred to in item (1) relates to insurance protection which the employee receives during any part of the taxable year. For example, if an employee is provided $25,000 of group-term life insurance for the first 6 months of his taxable year, and $50,000 of such insurance for the remaining 6 months of such year, the cost of $20,000 of such insurance for the second 6-month period is includible in his gross income (assuming the employee pays nothing toward the cost of such insurance).

Contributions with respect to more than one policy

If an employee pays any amounts toward the purchase of group-term life insurance on his life during a taxable year, the amount of all such payments reduce the amounts includible in gross income under section 79 even though such payments are made with respect to a period during which his insurance protection did not exceed $30,000. For example, assuming the facts of the case described in the preceding paragraph, if the employee made no payments with respect to the $50,000 of group-term life insurance provided during the second 6 months of his taxable year but made payments with respect to the $25,000 of group-term life insurance provided during the first 6 months, the payments made by the employee reduce the amount includible in his gross income with respect to the group-term life insurance provided during the second 6 months.

Contributions attributable to future years

In determining the amount includible in income for any taxable year, there is not taken into account under item (2) any amounts paid by the employee for group-term life insurance provided (or to be provided) for a different taxable year. Thus, if part of an employee's payment during a taxable year represents a prepayment for insurance to be provided after his retirement, such part does not reduce the amount includible in his gross income for the current taxable year.

(*b*) *Exceptions.*—The new section 79(b) contains three exceptions to the general rule of section 79(a).

Retired and disabled employees

Paragraph (1) of section 79(b) provides an exception to the general rule in the case of retired and disabled employees. Under this exception, the cost of group-term life insurance on the life of an individual which is provided (under a policy carried directly or indirectly by an employer) after such individual has terminated his employment with such employer and has reached the retirement age with respect to such employer or has become disabled (within the meaning of par. (3) of sec. 213(g) of the code, determined without regard to par. (4) thereof) is not included in such individual's gross income. For this purpose the determination of the retirement age with respect to an employer is to be made in the same manner as for purposes of the exclusion for wage continuation payments under section 105(d) of the code. In a case where an employee retires or becomes disabled during a taxable year, the exception provided by paragraph (1) applies only to the portion of the cost of his group-term life insurance which is attributable to the part of the year during which the employee was retired or disabled.

Employer or charity a beneficiary

Paragraph (2) of the new section 79(b) contains another exception to the general rule. This exception provides that section 79(a) does not apply to the cost of any portion of the group-term life insurance on the life of an employee provided during part or all of the taxable year of the employee under which the employer is directly or indirectly the beneficiary, or under which a person described in section 170(c) of the code (relating to definition of charitable contributions) is the sole beneficiary, for the entire period during such taxable year for which the employee receives such insurance.

Insurance provided by qualified employee trust

Paragraph (3) of the new section 79(b) contains a third exception to the general rule. Under paragraph (3), section 79(a) does not apply to the cost of any group-term life insurance provided under a contract to which section 72(m)(3) of the code applies. In general, section 72(m)(3) provides rules for the tax treatment of life insurance provided under contracts purchased by qualified employee trusts or annuity plans. Accordingly, the exception provided by paragraph (3) makes it clear that the tax treatment of group-term life insurance provided under such a contract is determined under the provisions of section 72(m)(3), and not under the provisions of the new section 79(a).

(*c*) *Determination of cost of protection.*—The new section 79(c) provides rules for determining the cost of group-term life insurance

protection for purposes of applying section 79 (a) and (b) and also for purposes of withholding under chapter 24 of the code.

Uniform premium table method

Paragraph (1) of the new section 79(c) provides that the cost of group-term life insurance protection on the life of an employee provided during any period is determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) to be set forth in a table prescribed in regulations by the Secretary of the Treasury or his delegate.

Policy cost method

Paragraph (2) of the new section 79(c) provides that, in lieu of using the uniform premium table, the employer may elect, with respect to any employee, to determine the cost of such employee's group-term life insurance on the basis of the average premium cost under the policy for the ages included within the age bracket which is applicable to the employee under the provisions of paragraph (1). For purposes of this method of computation of the cost of group-term life insurance, the net premium cost is to be used. Thus any return of premiums or dividends to policyholders is taken into account. The election provided by this paragraph is to be made at such time and in such manner as is prescribed by regulations of the Secretary of the Treasury or his delegate. A separate election may be made for each employee who is furnished group-term life insurance by the employer. In the absence of an election by the employer under the provisions of paragraph (2), the determination of the cost of insurance provided for an employee shall be made on the basis of the uniform premiums in accordance with the rules provided in paragraph (1) of section 79(c).

The election provided under paragraph (2) is not available in the case of a group-term life insurance policy under which the premium is computed other than on the basis of the cost of the insurance at the ages (or at the age brackets provided in the uniform premium table) of the individuals comprising the group. Thus, for example, the policy cost method may not be used in the case of a policy under which the premium is computed on the basis of 10-year age brackets or on the basis of the mortality experience of the group as a whole.

Employed individuals over age 64

Paragraph (3) of the new section 79(c) provides that, in the case of an employee who has attained age 64, the cost determined under paragraph (1) or (2), as the case may be, cannot exceed the cost which would be determined under such paragraph with respect to the individual if he were age 63. Thus, under the rule provided by this paragraph, the maximum cost to be used in determining the amount includible in gross income under the provisions of section 79(a) is the cost applicable at the 60 to 64 age bracket.

Example.—The operation of the new section 79 may be illustrated by the following example. Assume that for a full taxable year an employee, age 52, is provided (under a policy carried by his employer) with $70,000 of group-term life insurance on his life and that his spouse is the beneficiary. Assume further that the uniform premium applicable at his age is $10.87 per $1,000 of protection and that the employee contributes $1 per $1,000 of protection. Based on these

facts, the amount includible in the employee's income is computed as follows:

Total group-term life insurance protection	$70, 000
Less $30,000 exclusion	30, 000
	40, 000
Cost of $40,000 of insurance (40×$10.87)	434. 80
Less: Employee's contribution (70×$1)	70. 00
Amount includible in employee's gross income	$364. 80

SECTION 203. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES (Continued)

Full-time life insurance salesmen

Subsection (a)(3) of section 203 of the bill amends section 7701(a)(20) of the code to provide that a full-time life insurance salesman who is considered an employee for purposes of chapter 21 of the code shall also be considered an employee for purposes of the new section 79 as well as for purposes of the new section 218 (relating to certain contributions by employees for group-term life insurance) which is added to the code by subsection (b) of section 203 of the bill.

(*b*) *Certain contributions by employees for group-term life insurance.*—Subsection (b) of section 203 of the bill adds a new section 218 to part VII of subchapter B of chapter 1 of the code (relating to additional itemized deductions for individuals).

The new section 218 provides that in the case of an employee who is provided group-term life insurance on his life for part or all of the taxable year under a policy (or policies) carried directly or indirectly by his employer (or employers), if the amount of such insurance is in excess of $30,000, there is allowed as a deduction for such taxable year the excess (if any) of (1) the amount paid by the employee toward the purchase of the portion of such insurance which exceeds $30,000, over (2) the cost of the portion of the insurance which exceeds $30,000 (such cost to be determined under par. (1) of sec. 79(c), relating to the uniform premium table method, applied without regard to par. (3) of such sec. 79(c)). In applying the new section 218, there is to be disregarded any insurance the cost of which is excepted from the application of subsection (a) of section 79 by subsection (b) thereof. Thus, if an employee is provided with group-term life insurance under a contract to which section 72(m)(3) applies, the amount of such insurance is disregarded in determining whether, for purposes of section 218, the employee is provided with more than $30,000 of group-term life insurance. Moreover, the cost of such insurance and the amount paid by the employee toward its purchase are disregarded in computing the amount of his deduction under section 218.

Example.—The operation of the new section 218 may be illustrated by the following example. Assume that for a full taxable year an employee, age 28, is provided (under a policy carried by his employer) with $40,000 of group-term life insurance on his life and that the cost of this insurance is subject to the provisions of section 79(a).

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Assume further that the uniform premium applicable at his age is \$2.11 per \$1,000 of protection and that the employee paid \$3 per \$1,000 of protection for the entire \$40,000 of insurance. Based on these facts, the amount deductible by the employee for the taxable year is computed as follows:

Portion of group-term life insurance in excess of \$30,000 (\$40,000 less \$30,000)	\$10, 000
Amount paid by the employee toward the purchase of \$10,000 of insurance (10×\$3.00)	30. 00
Less: cost under uniform premium table of \$10,000 of insurance (10×\$2.11)	21. 10
Amount deductible by the employee	\$8. 90

(c) *Withholding.*—Subsection (c) of section 203 of the bill amends section 3401(a) of the code (relating to definition of wages) by adding a new paragraph (14) at the end thereof. Under this new paragraph, the term "wages" (for purposes of withholding of income tax at source on wages) includes remuneration paid in the form of group-term life insurance on the life of an employee, but only to the extent that the cost of such insurance is includible in the employee's gross income under the provisions of section 79(a) of the code (added by this section of the bill). For purposes of the new paragraph (14), the amount of "remuneration paid" in the form of group-term life insurance is determined with reference to the cost of the life insurance (computed as provided in sec. 79(c)) provided to the employee, without regard to the time when the premium is paid by the employer. Moreover, it includes the cost of insurance provided under policies carried both directly and indirectly by the employer. Under the provisions of the new paragraph (14), each employer paying remuneration to an employee in the form of group-term life insurance determines the amount includible in such employee's gross income under section 79(a) of the code as if such employer were the only employer paying the employee remuneration in the form of such insurance. Thus, an employer computes the amount includible in the gross income of an employee by applying a full \$30,000 exclusion, without regard to whether another employer may also be furnishing group-term life insurance for the same employee during the same period.

(d) *Effective dates.*—Subsection (d) of section 203 of the bill provides that the amendments made by subsections (a) and (b) of such section apply with respect to group-term life insurance provided after December 31, 1963, in taxable years ending after such date; and that the amendment made by subsection (c) applies with respect to remuneration paid after December 31, 1963, in the form of group-term life insurance provided after such date.

SECTION 204. INCLUSION IN GROSS INCOME OF REIMBURSED MEDICAL EXPENSES TO THE EXTENT THAT THE REIMBURSEMENT EXCEEDS THE EXPENSES

(a) *General rule.*—Subsection (a) of section 204 of the bill adds a new section 80 to part II of subchapter B of chapter 1 of the code (relating to items specifically included in gross income).

The new section 80 provides that, notwithstanding any other provision of subchapter B of chapter 1 of the code (relating to computa-

tion of taxable income), amounts received through accident or health insurance for medical expenses are includible in gross income to the extent that the aggregate of such amounts received for any personal injury or sickness exceeds the aggregate amount of medical expenses incurred by the taxpayer for such personal injury or sickness.

Section 80 provides that the term "medical expenses" means expenses for medical care as defined in section 213(e) of the code, other than amounts paid for accident or health insurance. Thus, premiums paid for accident or health insurance are not taken into account in determining the aggregate amount of medical expenses incurred with respect to any personal injury or sickness. Section 80 does not apply to amounts received through accident or health insurance other than for medical expenses. The term "accident or health insurance" as used in section 80 has the same meaning as under sections 104 and 105 of the code.

(*b*) *Clerical amendment.*—Subsection (b) of section 204 of the bill makes a clerical amendment to the table of sections for part II of subchapter B of chapter 1 of the code.

(*c*) *Technical amendment.*—Subsection (c) of section 204 of the bill amends section 105(e) of the code to provide that, for purposes of the new section 80, amounts received through accident and health plans described in section 105(e) are treated as received through accident or health insurance.

(*d*) *Effective date.*—Subsection (d) of section 204 of the bill provides that the amendments made by subsections (a), (b), and (c) of such section apply to taxable years beginning after December 31, 1963.

SECTION 205. AMOUNTS RECEIVED UNDER WAGE CONTINUATION PLANS

(*a*) *Wage continuation plans.*—Subsection (a) of section 205 of the bill amends section 105(d) of the code, which presently provides that gross income does not include amounts (up to $100 a week) received by an employee from his employer if such amounts constitute wages (or payments in lieu of wages) for a period during which such employee is absent from work due to personal injuries or sickness. The second sentence of section 105(d) presently provides that in the case of an absence from work due to sickness, the exclusion provided by section 105(d) does not apply to amounts received by the employee which are attributable to the first 7 calendar days of the absence from work unless the employee is hospitalized for at least 1 day during such period of absence. The 7-day waiting period does not apply if the absence from work is due to a personal injury.

Under the amendment made by this section of the bill, the section 105(d) exclusion does not apply to amounts attributable to the first 30 calendar days of a period of absence from work on account of personal injuries or sickness. This 30-day waiting period applies whether or not the employee is hospitalized during the period of absence from work and without regard to whether the absence from work is due to personal injury or sickness.

(*b*) *Effective date.*—Subsection (b) of section 205 of the bill provides that the amendment made by subsection (a) applies to payments attributable to periods of absence which begin after December 31, 1963. Thus, the 30-day waiting period prescribed by section 105(d),

as amended by this section of the bill, does not apply in the case of any period of absence from work which begins prior to January 1, 1964, even though such absence continues after such date.

SECTION 206. EXCLUSION FROM GROSS INCOME OF GAIN ON SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65

(*a*) *In general.*—Subsection (a) of section 206 of the bill redesignates section 121 of the code as section 122 and inserts a new section 121 in part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income). Under present law, tax is imposed in respect of the gain on the sale or exchange of a residence unless a nonrecognition provision (sec. 1033 (involuntary conversions) or 1034 (sale or exchange of residence)) applies. The new section 121 generally provides an exemption from this tax in the case of a sale or exchange of a residence by an individual who has attained age 65.

SECTION 121. GAIN FROM SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65

(*a*) *General rule.*—The new section 121(a) provides that a taxpayer may, under certain circumstances, elect to exclude from gross income gain realized on the sale or exchange of property which was his principal residence. Subject to the other provisions of section 121, the election may be made only if (1) the taxpayer attained the age of 65 before the date of the sale or exchange of his principal residence, and (2) during the 8-year period ending on the date of the sale or exchange of the property the taxpayer owned and used the property as his principal residence for periods aggregating 5 years or more.

The requirements of ownership and use for periods aggregating 5 years or more may be satisfied by establishing ownership and use for 60 full months or for 1,825 days (365×5). In establishing whether a taxpayer has satisfied the requirement of 5 years of use, short temporary absences such as for a vacation or other seasonal absence (although accompanied with rental of the residence) are counted as periods of use.

The application of section 121(a) is illustrated by the following examples:

Example (1).—Taxpayer A owned and used his house as his principal residence continually since 1946. On January 1, 1962, A retires and moves to another State with his wife, at which time he is over 65. A leases his house from such date until July 1, 1964, at which time he sells it. A may make an election under section 121 with respect to any gain on such sale since he has owned and used such house as his principal residence for 5 years out of the 8 years preceding the sale.

Example (2).—Taxpayer B lived with his son and daughter-in-law in a house owned by his son from 1957 through 1963. On January 1, 1964, he purchased this house and on December 31, 1967, he sold it. Although B used the property as his principal residence for more than 5 years, he is not entitled to make an election under section 121(a) in respect of such sale since he did not own and use the residence for a period aggregating 5 years during the 8-year period ending on the date of the sale.

Example (3).—Taxpayer C, a college professor, purchased and moved into a house on January 1, 1960, and used it as his principal residence continuously to February 1, 1964, on which date he went abroad for a 1-year sabbatical leave. During a portion of the period of leave the property was unoccupied and it was leased during the balance of the period. On March 1, 1965, 1 month after returning from such leave, he sold the house. Since his leave is not considered to be a short temporary absence for purposes of the new section 121(a), the period of such leave may not be included in determining whether C used the house as his principal residence for periods aggregating 5 years or more. Thus, C is not entitled to make an election under subsection (a) since he did not use the residence for the requisite period.

(*b*) *Limitations.*—The new section 121(b) provides certain limitations on the application of section 121(a).

Where adjusted sales price exceeds $20,000

Paragraph (1) of section 121(b) imposes a limitation on the amount of gain which may be excluded from gross income under section 121(a) in any case where the "adjusted sales price" of the residence exceeds $20,000. The term "adjusted sales price" has the meaning assigned to it by section 1034(b)(1) of the code, determined without regard to section 121(d)(7). In general, the term means the amount realized from the sale or exchange less certain expenses for work performed on the residence to assist in its sale. If the adjusted sales price exceeds $20,000, the amount of gain excluded from the taxpayer's gross income (if the taxpayer makes the election) is that portion of the gain which bears the same ratio to the total amount of such gain as $20,000 bears to the adjusted sales price.

The application of the limitation in section 121(b)(1) is illustrated by the following example:

Example.—Assume that A sells his principal residence for $30,400; that the adjusted sales price is $30,000 (selling price reduced by fixing-up expenses described in sec. 1034(b) of $400); and that A's gain from the sale is $15,000. The portion of the gain which bears the same ratio to the total amount of such gain as $20,000 bears to the adjusted sales price is $10,000 ($20,000/$30,000×$15,000). Thus, $10,000 is the portion of the gain excludable from gross income pursuant to an election under section 121(a).

Application to only one sale or exchange

Paragraph (2) of section 121(b) makes section 121(a) inapplicable to certain sales or exchanges of principal residences. Paragraph (2) prohibits a taxpayer from making an election to exclude from gross income gain from the sale or exchange of a principal residence if there is in effect (1) an election made by the taxpayer, under the provisions of section 121(a), in respect of any other sale or exchange of a residence, or (2) an election made by the taxpayer's spouse, under the provisions of section 121(a), in respect of any other sale or exchange of a residence (without regard to whether at the time of such sale or exchange such spouse was married to the taxpayer).

If the taxpayer and his spouse, before their marriage, each owned and used a separate residence and if (after their marriage) both residences are sold, whether or not in a single transaction, an election under section 121(a) may be made with respect to a sale of either

residence (but not with respect to both residences) if the age, ownership, and use requirements are met.

The application of section 121(b)(2) is illustrated by the following example:

Example.—Assume that while A and B were married, A sold his separately owned residence and made an election under section 121(a) in respect of such sale. Pursuant to the requirement of section 121(c) (discussed below) B joined in such election. Subsequently, A and B are divorced and B marries C. While B and C are married, C sells his residence. C is not entitled to make an election under section 121(a) since an election by B, his spouse, is in effect at the time of such sale.

(*c*) *Election.*—The new section 121(c) specifies that a taxpayer may make an election under section 121(a) in respect of a particular sale (or may revoke any such election) at any time before the expiration of the period for making a claim for credit or refund of Federal income tax for the taxable year in which the sale or exchange occurred. The manner in which an election may be made or revoked is to be prescribed in regulations issued by the Secretary of the Treasury or his delegate. Section 121(c) also provides that a taxpayer who is married at the time of the sale or exchange (1) may not make an election under section 121(a) unless his spouse (at the time of the sale or exchange) joins him in such election, and (2) may not revoke an election previously made by him unless his spouse (at the time of the sale or exchange) joins him in the revocation. (See par. (6) of sec. 121(d), relating to determination of marital status, and the discussion thereunder.) If the taxpayer's spouse dies after the sale or exchange but before the expiration of the time for making an election under this section (and an election was not made by the husband and wife), the deceased spouse's personal representative (e.g., administrator or executor) must join with the taxpayer in making an election. Likewise, the personal representative of the taxpayer's deceased spouse must join in a revocation of any election previously made by the taxpayer and his spouse.

(*d*) *Special rules.*—The new section 121(d) consists of seven paragraphs, each containing a special rule. These special rules are separately discussed below.

Property held jointly by husband and wife

Paragraph (1) of section 121(d) provides that if (1) a residence is held by a husband and wife as joint tenants, tenants by the entirety, or community property, (2) a joint return is made by the husband and wife for the taxable year in which such residence is sold or exchanged, and (3) one spouse satisfies all the requirements of section 121(a) (i.e., meets the age requirement and the requirements of ownership and use of the residence), then both the husband and wife are treated as satisfying the age, ownership, and use requirements of section 121(a). Thus, if the above conditions exist and one spouse meets the requirements of section 121(a), the other spouse will be treated as meeting all such requirements.

Property of deceased spouse

Paragraph (2) of section 121(d) provides that a taxpayer is treated as satisfying the holding and use requirements of section 121(a) with

respect to property if (1) his spouse is deceased on the date of the sale or exchange of such property, and (2) such spouse had, during the 8-year period ending on the date of the sale or exchange of the property, satisfied such holding and use requirements with respect to such property. Paragraph (2), however, has no application if the surviving spouse is married at the time of the sale or exchange of such property, or if an election made by the deceased spouse under section 121(a) is in effect with respect to any other sale or exchange.

The application of the special rule in paragraph (2) is illustrated by the following example:

Example.—H and W become husband and wife on January 1, 1964, and on and after such date use as their principal residence property which H has owned since January 1, 1957, and which he used as his principal residence for the period from January 1, 1957, until his marriage on January 1, 1964. H dies on January 1, 1966, and W inherits the property and continues to use the property as her principal residence. W sells the property on December 31, 1967, at which time she is over 65 and not married. H, during the 8-year period ending on the date of the sale (January 1, 1960, through December 31, 1967), satisfied the 5-year use and ownership requirements of section 121(a)(2) with respect to such property since during this 8-year period he had owned and used the property as his principal residence for 6 years (1960 through 1965). Accordingly, W may make an election under section 121(a).

Tenant-stockholder in cooperative housing corporation

Paragraph (3) of section 121(d) provides that an individual who holds stock as a "tenant-stockholder" in a "cooperative housing corporation," as those terms are defined in section 216 of the code, may be eligible to make an election under section 121(a) in respect of the sale or exchange of such stock. In determining whether the taxpayer meets the requirements of section 121(a), the ownership requirements of such section are applied to the holding of such stock and the use requirements of such section are applied to the house or apartment which the individual was entitled to occupy because of such stock ownership.

Involuntary conversions

Paragraph (4) of section 121(d) provides that destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

Property used in part as principal residence

Paragraph (5) of section 121(d) provides that where a taxpayer can satisfy the ownership and use requirements of section 121(a) only with respect to a portion of the property sold, then section 121 shall apply only with respect to so much of the gain from the sale or exchange of the property as is attributable to such portion. For example, if taxpayer A, an attorney, uses a portion of the property constituting his principal residence as a law office for a period in excess of 3 years out of the 8 years preceding the sale of such residence, then section 121 shall not apply with respect to so much of the gain on the sale of the property as is allocable to the portion of the property used as a law office. If an allocation of the gain from the sale or exchange of property is required, such allocation is made in ac-

cordance with regulations prescribed by the Secretary of the Treasury or his delegate.

Determination of marital status

Paragraph (6) of section 121(d) provides that marital status is to be determined as of the date of the sale or exchange of the residence. An individual who on the date of the sale or exchange is legally separated from his spouse under a decree of divorce or of separate maintenance is not considered as married on such date.

Application of sections 1033 and 1034

Paragraph (7) of section 121(d) provides that in applying sections 1033 (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence) of the code, the amount realized from the sale or exchange of property used as one's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from gross income pursuant to an election made under section 121.

SECTION 206. EXCLUSION FROM GROSS INCOME OF GAIN ON SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65 (Continued)

(*b*) *Technical and clerical amendments.*—Subsection (b) of section 206 of the bill contains certain technical and clerical amendments.

Paragraph (1) of section 206(b) amends section 6012(c) of the code (relating to persons required to make returns of income) to provide that for purposes of section 6012 of the code (which requires individuals with gross incomes of $600 or more to file returns) gross income is to be computed without regard to the exclusion provided for in the new section 121.

Paragraph (2) of section 206(b) amends the table of sections for part III of subchapter B of chapter 1 to reflect the addition of the new section 121.

Paragraphs (3) and (4) of section 206(b) amend, respectively, sections 1033(h) (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence) of the code by adding cross references to the new section 121.

(*c*) *Effective date.*—Subsection (c) of section 206 provides that the amendments made by subsections (a) and (b) of such section apply to dispositions made after December 31, 1963, in taxable years ending after such date.

SECTION 207. DENIAL OF DEDUCTION FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

(*a*) *In general.*—Subsection (a) of section 207 of the bill revises subsections (a), (b), and (c) of section 164 of the code (relating to deduction for taxes).

Under the existing provisions of section 164 a deduction is allowable for all taxes paid or accrued within the taxable year, with certain exceptions. In general, the exceptions are certain Federal taxes (including income taxes); estate, inheritance, legacy, succession, and gift taxes; taxes assessed against local benefits of a kind tending to

increase the value of the property assessed; income, war profits, and excess profits taxes imposed by the authority of any foreign country, if the taxpayer chooses to take to any extent the benefits of section 901 of the code (relating to the foreign tax credit); and taxes on real property to the extent that section 164(d) requires such taxes to be treated as imposed on another taxpayer.

SECTION 164. TAXES

(*a*) *General rule.*—Section 164(a), as amended by this section of the bill, provides that the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.
(2) State and local personal property taxes.
(3) State and local, and foreign, income, war profits, and excess profits taxes.
(4) State and local general sales taxes.

In addition, subsection (a) allows as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or in carrying on an activity described in section 212 of the code (relating to expenses for production of income).

Real property taxes

Paragraph (1) of section 164(a) lists State and local and foreign real property taxes as the first category of deductible taxes. The term "real property taxes" means taxes imposed on interests in real property. Those real property taxes which are now deductible under section 164 remain so; those real property taxes which are not presently deductible are not made deductible by the amendment.

Personal property taxes

Paragraph (2) of section 164(a) lists State and local personal property taxes as the second category of deductible taxes. Under this paragraph personal property taxes as defined in section 164(b) (described below) are deductible.

Income, war profits, and excess profits taxes

Paragraph (3) of section 164(a) lists State and local and foreign income, war profits, and excess profits taxes as the third category of deductible taxes. Those income, war profits, and excess profits taxes which are now deductible under section 164 remain so; such taxes which are not presently deductible are not made deductible by the amendment.

General sales taxes

Paragraph (4) of section 164(a) lists State and local general sales taxes as the fourth category of deductible taxes. No foreign sales tax is deductible under this paragraph. In order to be deductible under this paragraph, State and local sales taxes must be general in nature. The definitions of State and local general sales taxes are set forth in section 164(b), described below.

Taxes paid or accrued in carrying on a trade or business or for the production of income

The last sentence of section 164(a) allows as a deduction State and local, and foreign, taxes not otherwise described in section 164(a)

which are paid or accrued within the taxable year in carrying on a trade or business or in carrying on an activity described in section 212 of the code (relating to expenses for the production of income). Such taxes which are now deductible under section 164 remain so; those which are not presently deductible under section 164 are not made deductible by the amendment.

(*b*) *Definitions and special rules.*—Section 164(b) as amended provides definitions and special rules for the application of section 164(a).

Personal property taxes

Paragraph (1) of section 164(b) defines the term "personal property tax" as an ad valorem tax which is imposed on an annual basis in respect of personal property.

To qualify as a personal property tax under this definition, a tax must meet three tests. The first test is that the tax must be ad valorem—that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem. For example, a motor vehicle tax based on weight, model year, and horsepower, or any of them, is not an ad valorem tax. However, a tax which is partly based on value and partly based on other criteria may qualify in part. For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.

The second test is that the tax must be imposed on an annual basis, even if collected more frequently or less frequently.

The third test is that the tax must be imposed in respect of personal property. A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. For example, an annual ad valorem tax qualifies as a personal property tax although it is denominated a registration fee imposed for the privilege of registering motor vehicles or of using them on the highways.

General sales taxes

Paragraph (2) of section 164(b) defines "general sales tax" and provides special rules for food, etc., for items taxed at different rates, for compensating use taxes, and for separately stated sales taxes.

Subparagraph (A) of section 164(b)(2) defines the term "general sales tax" as a tax which is imposed at one rate in respect of the sale at retail of a broad range of classes of items. To qualify under this definition a tax must meet two tests. The first test is that the tax must be a sales tax—that is, a tax in respect of sales at retail. This may include a tax imposed on persons engaged in selling property at retail or furnishing services at retail, for example, if the tax is measured by gross sales price or by gross receipts from sales or services. Rentals qualify as sales at retail if so treated under applicable State sales tax law.

The second test is that the tax must be general—that is, imposed at one rate in respect of the retail sales of a broad range of classes of items. A sales tax is considered to be general although imposed on sales of various classes of items at more than one rate, provided that one rate applies to the retail sales of a broad range of classes of items. The term "items" includes both commodities and services.

A sales tax which is general is usually imposed at one rate in respect of the retail sales of all tangible personal property (with exceptions and additions). However, a sales tax which applies at one rate with respect to retail sales of specified classes of items also qualifies as general if the specified classes represent a broad range of classes of items. For example, the present Wisconsin selective sales tax so qualifies. However, a selective sales tax which does not apply to the retail sales of a broad range of classes of items is not general. For example, a tax which applies only to sales of gasoline, alcoholic beverages, tobacco, admissions, luxury items, and a few other items is not general. Similarly, a tax imposed solely on services is not general.

A tax is imposed at one rate only if it is imposed at that rate on generally the same base for all items subject to tax. For example, a sales tax imposed at a 3-percent rate on 100 percent of the sales price of some classes of items and at a 3-percent rate on 50 percent of the sales price of other classes of items would not be imposed at one rate with respect to all such classes. However, a tax is considered to be imposed at one rate although it allows dollar exemptions, if the exemptions are designed to exclude sales under a certain dollar amount. For example, a tax may be imposed at one rate although it applies to all sales of tangible personal property but applies only to items costing over 10 cents.

Subparagraph (B) of section 164(b)(2) provides special rules in the case of food, clothing, medical supplies, and motor vehicles. The fact that a sales tax exempts food, clothing, medical supplies, and motor vehicles, or any of them, is not taken into account in determining whether the tax applies to a broad range of classes of items. The fact that a sales tax applies to food, clothing, medical supplies, and motor vehicles, or any of them, at a rate which is lower than the general rate is not taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. For purposes of this section, the term "food" means food for human consumption off the premises where sold, and the term "medical supplies" includes drugs, medicines, and medical devices.

Subparagraph (C) of section 164(b)(2) provides a special rule in the case of items taxed at different rates. In general, no deduction is allowed for a general sales tax in respect of any item if the tax is imposed on such item at a rate other than the general rate of tax. The general rate of tax is the one rate which qualifies a tax in a taxing jurisdiction as a general sales tax because the tax is imposed at such one rate on a broad range of classes of items. There can be only one general rate of tax in any one taxing jurisdiction. However, a general sales tax imposed at a lower rate or rates on food, clothing, motor vehicles, and medical supplies, or any of them, may nonetheless be deductible with respect to such items. For example, the District of Columbia sales tax is imposed at 1 percent with respect to food, imposed at 3 percent with respect to substantially all other classes of tangible personal property, and imposed at 4 percent with respect to transient accommodations. Taxes paid at the 1 percent and the 3 percent rates are deductible, but tax paid at the 4 percent rate is not deductible.

Subparagraph (D) of section 164(b)(2) defines a compensating use tax and provides a special rule with respect to such tax. The term "compensating use tax" is defined, in respect of any item, as a tax

which is imposed on the use, storage, or consumption of such item and which is complementary to a general sales tax which is deductible with respect to sales of similar items. A compensating use tax in respect of such an item is treated as a general sales tax.

In general, a use tax on an item is complementary to a general sales tax on similar items if the use tax is imposed on an item which was not subject to such general sales tax but which would have been subject to such general sales tax if the sale of the item had taken place within the jurisdiction imposing the use tax. For example, a tax imposed by State A on the use of a motor vehicle purchased in State B is complementary to the general sales tax of State A on similar items, if the latter tax applies to motor vehicles sold in State A.

Since a compensating use tax is treated as a general sales tax, it is subject to the rule of subparagraph (C) of section 164(b)(2) that no deduction is allowed for a general sales tax imposed in respect of an item at a rate other than the general rate of tax (except in the case of lower rates on the sale of food, clothing, medical supplies, and motor vehicles).

Subparagraph (E) of section 164(b)(2) provides a special rule in the case of separately stated general sales taxes. If a tax is imposed on the seller, but the amount of such tax is separately stated, then (as under existing law), to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount is treated as a tax imposed on, and paid by, such consumer.

State or local taxes

Paragraph (3) of section 164(b) defines a State or local tax to include only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

Foreign taxes

Paragraph (4) of section 164(b) defines a foreign tax to include only a tax imposed by the authority of a foreign country. A tax imposed by a political subdivision of a foreign country is considered to be imposed by the authority of that foreign country.

(c) *Deduction denied in case of certain taxes.*—Section 164(c) as amended denies the deduction of certain taxes under section 164.

Paragraph (1) of section 164(c) denies a deduction for taxes assessed against local benefits of a kind tending to increase the value of the property assessed, except for the portion of such taxes properly allocable to interest or maintenance charges. This paragraph retains the rules of present law now contained in paragraph (5) of section 164(b) except that present law allows the deduction of local benefit taxes levied by a special taxing district if the taxes meet certain tests. This exception is not continued.

Paragraph (2) of section 164(c) denies a deduction for taxes on real property to the extent that section 164(d) (relating to apportionment of taxes on real property between seller and purchaser) requires such taxes to be treated as imposed on another taxpayer. This paragraph retains the rule presently contained in paragraph (7) of section 164(b).

The rules presently contained in the other paragraphs of section 164(b), with the exception of paragraph (3), are retained in the new

section 275 (described below). The existing paragraph (3) (relating to denial of deduction under section 164 for Federal import duties and Federal excise and stamp taxes) is eliminated as unnecessary in view of the revision of the language of section 164 by this section of the bill.

SECTION 207. DENIAL OF DEDUCTION FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES (Continued)

(*b*) *Technical amendments.*—Paragraph (1) of section 207(b) of the bill amends the first sentence of section 164(f) of the code (relating to payments for municipal services in atomic energy communities) by inserting "State" before "real property taxes." Thus, payments for municipal services in atomic energy communities which are presently treated as real property taxes paid or accrued continue to be deductible under the amended section 164(a).

Paragraph (2) of section 207(b) of the bill adds to section 164(g) of the code a new cross reference to the new section 275 (discussed below) which continues the disallowance of the deduction of certain taxes.

Paragraph (3) of section 207(b) of the bill amends part IX of subchapter B of chapter 1 of the code (relating to items not deductible) by adding a new section 275 at the end thereof. The new section 275 continues the denial of a deduction for the following taxes: Federal income taxes (deduction presently denied under sec. 164(b)(1)), Federal war profits and excess profits taxes (deduction presently denied under sec. 164(b)(2)), estate, inheritance, legacy, succession, and gift taxes (deduction presently denied under sec. 164(b)(4)), and foreign income and profits taxes if the taxpayer claims a foreign tax credit under section 901 (deduction presently denied under sec. 164(b)(6)).

Paragraphs (4) through (8) of section 207(b) of the bill make conforming amendments to the following sections of the code to reflect the addition of the new section 275: section 535(b) (relating to adjustments to accumulated taxable income), section 545(b) (relating to adjustments to personal holding company taxable income), section 556(b) (relating to adjustments to foreign personal holding company taxable income), section 901(d) (relating to credit for taxes imposed by foreign countries and by possessions of United States), and section 903 (relating to credit for taxes imposed by a foreign country in lieu of income, etc., taxes).

(*c*) *Effective date.*—Subsection (c) of section 207 of the bill provides that the amendments made by section 207 apply to taxable years beginning after December 31, 1963.

SECTION 208. PERSONAL CASUALTY AND THEFT LOSSES

(*a*) *Limitation on amount of casualty or theft loss deduction.*—Subsection (a) of section 208 of the bill amends section 165(c)(3) of the code (relating to personal losses of property of individual taxpayers which arise from fire, storm, shipwreck, or other casualty, or from theft) by denying a deduction for the first $100 of loss arising from each casualty or theft.

Section 165(a) of the code presently provides that, in general, a taxpayer may deduct a loss sustained during the taxable year which is not compensated for by insurance or otherwise. Section 165(c)

limits this general provision in the case of an individual to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

New $100 floor

Subsection (a) of section 208 of the bill amends section 165(c)(3) of the code to provide that the deduction under the third category of deductible losses of individuals is allowable only to the extent that the amount of loss arising from each casualty or theft exceeds $100.

Single casualty or theft

The $100 floor applies separately in respect of the loss arising from each casualty or theft. In applying the $100 floor, it is first necessary to determine whether a loss arose from a single casualty or theft. Events closely related in origin generally give rise to a single casualty or theft. For example, if a storm damages a taxpayer's residence and his automobile parked in his driveway, a single casualty is involved. Similarly, if a hurricane causes high waves and a taxpayer suffers both wind and flood damage to his summer residence, a single casualty is involved.

Husband and wife

For purposes of applying the $100 floor, a husband and wife filing a joint return for the taxable year in which the loss is allowed as a deduction are treated as one individual. If a husband and wife file a joint return for such taxable year, only one $100 floor applies in respect of each casualty or theft regardless of whether the loss is sustained in respect of jointly owned or separately owned property. If a husband and wife file separate returns, each is subject to a $100 floor in respect of each casualty or theft, regardless of whether the property damaged or stolen is owned jointly or separately. The joint return test applies to the taxable year in which the deduction is allowed. Thus if a disaster loss (as defined in sec. 165(h) of the code) occurs to property of a husband and wife in February 1965 and the taxpayers elect to take the deduction on their 1964 income tax return, a single $100 floor will apply if a joint return is filed for 1964.

Other individual taxpayers

Individual taxpayers other than husband and wife are subject to a separate $100 floor with respect to each casualty or theft, even though property of other persons is damaged or stolen in connection with the same casualty or theft. For example, if a fire damages a house and household goods of a single individual, as well as property of a visiting nephew which is in the same house, the single individual is subject to one $100 floor and the nephew is subject to a separate $100 floor.

Property used partially for business

In the case of a casualty or theft loss of property used partially for business and partially for personal purposes, the $100 floor applies only to the net loss attributable to the portion of the property used for personal purposes. For example, if a casualty causes damage in the amount of $1,000 to a taxpayer's automobile having an adjusted basis of $2,000, which is used 50 percent for business and 50 percent for

personal purposes, and the taxpayer's insurance recovery with respect to the casualty is $900, the taxpayer has a net loss of $100. Fifty percent of this loss, or $50, is considered a business loss, and is fully deductible. The remaining $50 of loss is personal, and is nondeductible because of the $100 floor.

Carrybacks and carryovers

Under section 172(d)(4)(C) of the code a personal casualty or theft loss is not treated as a nonbusiness expense for purposes of computing a net operating loss. The $100 floor applies in the computation of the net operating loss, but the net operating loss carried back or carried over is not again reduced in the year to which carried.

(*b*) *Effective date.*—Subsection (b) of section 208 of the bill provides that the amendment made by subsection (a) applies to losses sustained after December 31, 1963, in taxable years ending after such date.

SECTION 209. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS

(*a*) *Certain organizations added to additional 10-percent charitable limitation.*—Subsection (a) of section 209 of the bill adds two new clauses to subparagraph (A) of section 170(b)(1) of the code (relating to limitations on deductions allowable to individuals for charitable contributions and gifts).

Section 170(a) of the code allows a deduction for charitable contributions to the types of organizations described in section 170(c) thereof, subject to the limitations imposed under section 170(b). Paragraph (1) of section 170(b) sets forth the limitations on deductions for charitable contributions which are made by individuals. Subparagraph (B) of such paragraph (1) imposes a general limitation of 20 percent of an individual's adjusted gross income (computed without regard to any net operating loss carryback) as the amount which he may deduct for charitable contributions during the taxable year. However, subparagraph (A) of paragraph (1) allows the deduction of an additional 10 percent of adjusted gross income for charitable contributions by an individual to certain specified organizations which are among those described in section 170(c)—in general, churches and certain educational organizations, hospitals, and medical research organizations, and certain organizations affiliated with State colleges or universities—with the consequence that a total deduction of up to 30 percent of adjusted gross income is possible for individual taxpayers who contribute at least 10 percent of their adjusted gross income to the types of organizations specified in subparagraph (A) of section 170(b)(1).

Subsection (a) of section 209 of the bill adds new clauses (v) and (vi) to subparagraph (A) of section 170(b)(1), expanding the types of organizations to which the additional 10 percent limitation is applicable. Clause (v) adds the category of governmental units described in section 170(c)(1). These include the United States, a State, a possession of the United States, a political subdivision of a State or possession, or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes. Clause (vi) adds all of the organizations described in section 170(c)(2) (certain nonprofit corporations, trusts, community chests, and funds or foundations

organized and operated exclusively for religious, charitable, etc. purposes), but only if those organizations normally receive a substantial part of their support from governmental units described in section 170(c)(1) or from direct or indirect contributions from the general public.

These amendments liberalize and make more uniform the application of the overall 30-percent limitation on deductions for charitable contributions by individuals to organizations described in paragraphs (1) and (2) of section 170(c) which rely, directly or indirectly, on the general public for financial support. In general, the additional 10-percent limitation will now be applicable to any contribution to a governmental unit described in paragraph (1) if such contribution is made exclusively for public purposes. The additional 10-percent limitation will also be applicable to any contribution to an organization described in paragraph (2) which normally receives a substantial part of its financial support in the form of contributions from governmental units described in paragraph (1) or from the general public or from a combination of these sources.

In determining whether an organization described in section 170(c)(2) normally receives a substantial part of its support from governmental units or the general public or both, the amount of contributions usually received by the organization from such sources is to be compared to the amount of financial support usually received by the organization from all other sources. In this connection, income received by an organization in the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption from income tax under section 501(a) of the code would be disregarded in making this determination. However, unrelated business taxable income (as defined in sec. 512 of the code) would be considered as financial support from sources other than contributions from governmental units or the general public in determining whether an organization normally receives a substantial part of its financial support from these sources.

In determining whether a substantial part of the contributions normally received by an organization described in section 170(c)(2) are from the general public, the test is whether a representative number of persons contribute to its financial support. Thus, the additional 10-percent limitation would be applicable to contributions to national charitable organizations which normally receive a substantial part of their financial support from a wide segment of the general public, and also to contributions to museums, libraries, civic centers, symphony orchestras, and similar organizations which normally derive a substantial part of their financial support from a representative number of persons in the communities where their activities are centered. However, it would not apply to foundations, trusts, and other organizations which normally derive their financial support almost entirely from the members of a single family or from a few individuals.

The amendments made by subsection (a) of section 209 of the bill apply (as provided in subsec. (d) of such section) with respect to contributions which are paid in taxable years beginning after December 31, 1963.

(b) 5-year carryover of certain charitable contributions made by corporations.—Subsection (b) of section 209 of the bill amends the second sentence of section 170(b)(2) (relating to limitation on corporate

excess charitable contribution carryovers) and paragraph (19) of section 381(c) of the code (relating to carryovers in certain corporate acquisitions of excess charitable contributions made by the distributor or transferor corporation prior to its acquisition). The effect of these changes is to extend the excess charitable contribution carryover from 2 to 5 years.

Section 170(b) of the code prescribes limitations upon the allowable deduction for charitable contributions to the types of organizations described in section 170(c). Section 170(b)(2) sets forth the limitations on deductions for charitable contributions which are made by corporations, imposing a limitation of 5 percent of the corporation's taxable income (computed without regard to any net operating loss carryback) on the amount which it may deduct for charitable contributions during the taxable year. In the event that the contributions made by a corporate donor exceed the 5-percent limitation, the second sentence of section 170(b)(2) currently provides for a 2-year carryover for such excess contribution.

Paragraph (1) of section 209(b) of the bill amends the second sentence of section 170(b)(2) by extending from two to five the number of succeeding taxable years to which the portion of a contribution paid in a taxable year which is in excess of the amount deductible in such year is carried over as a deduction. For example, a corporation which contributes an amount in excess of the 5-percent limitation for the taxable year 1964 would be permitted to deduct such excess (until exhausted) in the years 1965, 1966, 1967, 1968, and 1969, in that order, to the extent that the 5-percent limitation computed for each of such years is not exceeded. No change from existing law is made with regard to the order of time in which the excess contribution carryover must be applied in succeeding taxable years.

Paragraph (2) of section 209(b) of the bill makes an amendment to paragraph (19) of section 381(c) of the code (parallel to the amendment extending the corporate carryover contained in par. (2) of sec. 170(b) from 2 years to 5 years) to allow a 5-year carryover of excess contributions made by the distributor or transferor corporation.

Section 381(a) of the code provides that a corporation which acquires the assets of another corporation in certain reorganizations and liquidations will succeed to, and take into account, certain items which are described in section 381(c). Paragraph (19) of section 381(c) presently provides that excess charitable contributions made by the distributor or transferor corporation in the taxable year ending on the date of distribution or transfer and the prior taxable year are deductible by the acquiring corporation in its first 2 taxable years which begin after the date of distribution or transfer, subject to the limitations imposed by section 170(b)(2).

In order to insure that an excess contribution is not deductible for more than 5 taxable years after the year of contribution, the amendment made by section 209(b)(2) of the bill provides that the taxable year of the transferor corporation beginning on or before the date of transfer is to be treated as a prior taxable year with reference to the taxable years of the acquiring corporation beginning after that date. This language makes it clear that an excess contribution made by the transferor corporation in the taxable year which includes the date of transfer is deductible by the acquiring corporation, subject to the limitations imposed in section 170(b)(2), only in its 5 succeeding

taxable years which begin after the date of transfer. This language also makes it clear that an excess contribution made by the transferor corporation in a taxable year prior to the taxable year of the transfer is only deductible by the transferor corporation, subject to the limitations imposed in section 170(b)(2), in its subsequent taxable years which begin on or before the date of transfer, and by the acquiring corporation in its taxable years beginning after that date. However, such excess deduction is not deductible by both the transferor and acquiring corporation during more than 5 taxable years (in the aggregate) after the contribution year.

No change from existing law is made with regard to the order of time in which the excess charitable contribution carryover must be applied by either the transferor or acquiring corporation in succeeding taxable years.

The amendments made by subsection (b) of section 209 of the bill apply in general (as provided in subsec. (d) of such section) with respect to contributions which are paid in taxable years beginning after December 31, 1963. A special rule is included in subsection (d) of section 209 of the bill to apply to a situation in which an accrual-basis corporation, pursuant to the provisions of section 170(a)(2) of the code, treats a contribution as paid during a prior taxable year. The amendment made by subsection (b) in such a case will apply to contributions which are treated as paid in taxable years which begin after December 31, 1963. The amendments made by subsection (b) of section 209 do not apply to contributions paid (or treated as paid) in taxable years beginning before December 31, 1963, whether or not they may be carried forward to taxable years which begin after December 31, 1963. Such contributions, as under present law, may be carried forward for only 2 years.

(c) *Future interests in tangible personal property.*—Subsection (c) of section 209 of the bill redesignates subsections (f) and (g) of section 170 of the code as subsections (g) and (h), respectively, and adds a new subsection (f).

Section 170(a) of the code provides that a charitable contribution is allowable as a deduction for the taxable year during which payment thereof is made. The new section 170(f) adds a special rule to determine when a charitable contribution consisting of a future interest in tangible personal property is considered to be paid. It provides, in effect, that the gift of such an interest will be considered to be incomplete for so long as the contributor (or a person standing in a relationship to the contributor described in sec. 267(b) of the code (relating to losses, expenses, and interest with respect to transactions between related taxpayers)) retains an intervening interest or right to the actual possession or enjoyment of the property. Under this special rule, a charitable contribution of a future interest in tangible personal property is deemed paid only in the taxable year when (1) all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired, or (2) all intervening interests in, and rights to the actual possession or enjoyment of, the property are held by a person or persons other than the contributor or related parties.

The special rule provided for in the new section 170(f) does not apply to a contribution in which the sole intervening interest or right is a nontransferable interest reserved by the donor which expires upon the donor's death, or, in the case of a joint gift by husband and

wife, the sole intervening interest or right is a nontransferable interest reserved by the donors which expires upon the death of whichever of such donors dies later. However, the right to transfer the reserved life interest to the donee of the future interest (i.e., the charity which receives the future interest contributed) is not treated as making a life estate transferable.

The new section 170(f) has no application with respect to contributions of future interests in real property or in intangible personal property. However, it expressly provides that a fixture which is intended to be severed from real property is to be treated as tangible personal property. For example, a charitable contribution of a future interest in a chandelier which is attached to a building is considered a contribution of a future interest in tangible personal property if the contributor intends that it be detached from the building when the charitable recipient's right to possession or enjoyment of it is to commence. However, if a remainder interest in the entire building is deeded to a single charitable organization without any provision for the severance of the chandelier, the contribution of the chandelier is treated as a contribution of real property and is immediately deductible, subject to the limitations imposed by section 170(b), as under existing law.

The term "future interest" has generally the same meaning as it has when used in section 2503 of the code. In general, it includes all interests which are to commence in use, possession, or enjoyment at some future time or date, regardless of whether such interests are designated as future interests under State law. The term includes not only situations in which the contributor's right to the use, possession, or enjoyment of property is reserved in the deed of gift, but also situations in which the contributor purports to give tangible personal property to a charitable organization without reserving to himself any right to the possession or enjoyment of the property but then enters into a "loan back" agreement with the charitable organization which has this effect.

The amendments made by section 209(c) of the bill apply to transfers of future interests made after December 31, 1963, in taxable years ending after such date. However, the transfer of a taxpayer's (or a related person's) retained interest in property with respect to which the taxpayer had previously transferred a future interest to a charity prior to December 31, 1963, will not give rise to a deduction for the value of such previously transferred future interest.

(*d*) *Effective dates.*—Subsection (d) of section 209 of the bill provides that the amendments made by subsections (a) and (b) of such section apply with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the code) in taxable years beginning after December 31, 1963, and that the amendments made by subsection (c) of such section apply to transfers of future interests made after December 31, 1963, in taxable years ending after that date.

SECTION 210. ONE-PERCENT LIMITATION ON MEDICINE AND DRUGS

(*a*) *General rule.*—Subsection (a) of section 210 of the bill amends section 213(b) of the code (relating to limitation of the medical expense deduction for amounts paid for medicines and drugs) by adding

at the end thereof a new sentence which removes the limitation in certain cases.

Section 213(b) of the code presently provides that amounts paid during the taxable year for medicines and drugs may be taken into account in computing the allowable medical expense deduction only to the extent that the aggregate of such amounts exceeds 1 percent of the taxpayer's adjusted gross income for such year.

Under the new sentence the 1-percent limitation of section 213(b) does not apply to amounts paid during the taxable year for medicines and drugs (1) for the care of the taxpayer and his spouse if either has attained age 65 before the close of the taxable year, or (2) for the care of the mother or father of the taxpayer or of his spouse if such parent is a dependent (as defined in sec. 152 of the code) of the taxpayer or his spouse and has attained age 65 before the close of the taxpayer's taxable year. Thus, the 1-percent medicine and drug floor is eliminated in all cases in which the 3-percent floor on deductibility of all medical expenses does not now apply. The 1-percent medicine and drug floor remains applicable in those cases in which the 3-percent floor now applies. For example, if neither the taxpayer nor his spouse has attained age 65 at the close of the taxable year, but a dependent parent of the taxpayer or his spouse has attained age 65 before the close of such taxable year, amounts paid by the taxpayer during the taxable year for medicines and drugs or for any other medical care of such parent are not subject to either the 1- or 3-percent limitation. However, amounts paid by such taxpayer during the taxable year for medicines and drugs or other medical care of himself or his spouse are subject to both the 1-percent limitation of section 213(b) and the 3-percent limitation of section 213(a)(1)(B).

(*b*) *Effective date.*—Subsection (b) of section 210 of the bill provides that the amendment made by subsection (a) applies to taxable years beginning after December 31, 1963.

SECTION 211. CARE OF DEPENDENTS

(*a*) *Child care allowance.*—Subsection (a) of section 211 of the bill amends section 214 of the code (relating to the deduction for expenses for care of certain dependents).

Under the existing provisions of section 214, all women (regardless of marital status) and widowers (including in such term divorced or legally separated men who have not remarried) are allowed a deduction for expenses (herein sometimes called "child care expenses") paid for the care of certain dependents if such care is for the purpose of enabling the taxpayer to be gainfully employed. The deduction cannot exceed $600 for any taxable year, regardless of the number of dependents for whom the taxpayer incurs or pays child care expenses. In the case of a married woman (other than a woman who is legally separated from her spouse under a decree of separate maintenance at the close of the taxable year and, under certain circumstances, a woman who has been deserted by her husband) whose husband is capable of self-support, (1) a deduction is allowable only if a joint income tax return is filed, and (2) the deduction otherwise allowable is reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $4,500, so that no deduction is allowable when the combined income is $5,100 or more. A "dependent" is defined as a

person with respect to whom the taxpayer is entitled to a deduction for an exemption under section 151(e)(1) of the code and who is either (1) a child or stepchild of the taxpayer who has not attained the age of 12 years or (2) physically or mentally incapable of caring for himself.

SECTION 214. EXPENSES FOR CARE OF CERTAIN DEPENDENTS

(*a*) *In general.*—Section 214(a) of the code, as amended by this section of the bill, retains all the substantive rules contained in the existing section 214(a) but expands the class of taxpayers eligible for the child-care deduction to include a husband whose wife is incapacitated or is institutionalized.

(*b*) *Limitations.*—Section 214(b) as amended, provides limitations on the deduction, differing in some respects from those of existing law.

Dollar amount

Paragraph (1)(A) of section 214(b) provides that, except as provided in paragraph (1)(B), the deduction under section 214(a) cannot exceed $600 for any taxable year. Paragraph (1)(B) provides that the $600 limit of paragraph (1)(A) is to be increased (to an amount not above $900) by the amount of expenses incurred by a taxpayer "for any period" during which the taxpayer has two or more dependents and is not subject to the provisions of section 214(b)(2), discussed below. The term "for any period," as used in paragraph (1)(B), may refer to the entire taxable year or any period of time within the taxable year.

Period during which taxpayer had two or more dependents

The first condition to be met in order for the $600 limit to be increased is that expenses for which a deduction in excess of $600 is claimed must have been incurred during a period when the taxpayer had two or more dependents (as defined in sec. 214(d)(1)). If a taxpayer filing income tax returns on a calendar year basis had, on January 1, 1964, two dependent children neither of whom attains the age of 13 or dies before January 1, 1965, such taxpayer is considered to have had two dependents (as defined in sec. 214(d)(1)) during the entire taxable year 1964. If, however, one of such children attains age 13 or dies during 1964, the taxpayer is considered to have had two such dependents for the period January 1, 1964, to the date on which such child attains age 13 or dies, and one such dependent thereafter.

Period during which paragraph (2) does not apply

The second condition to be met in order for the $600 limit to be increased is that expenses for which a deduction in excess of $600 is claimed must have been incurred during a period when the provisions of paragraph (2) of section 214(b) do not apply to the taxpayer. Paragraph (2) has application only in the case of a woman who is married. Accordingly, in the case of any man or in the case of a woman who is single during the entire taxable year (including a woman who pursuant to the provisions of sec. 214(d)(5) is not considered as married), the period during which paragraph (2) does not apply is the entire taxable year. In the case of a woman who is married during the entire taxable year, the period (if any) during which paragraph (2) does not apply is the period, or periods, within

the taxable year during which her husband is incapable of self-support because he is mentally or physically defective. If a woman marries during the taxable year, or if her husband dies during the taxable year, the period within the taxable year during which paragraph (2) does not apply also includes the portion of the taxable year during which the woman was single.

Working wives

Except as noted below, paragraph (2) of section 214(b) continues without change the existing limitations on the deduction allowable to certain married women. These limitations are that a deduction is not allowed unless the taxpayer files a joint return with her husband and that the deduction otherwise allowable is reduced to the extent that the couple's combined adjusted gross income exceeds $4,500. However, the provisions imposing the limitations on married women are amended to make it clear that such limitations are not applicable to a taxpayer whose husband is incapable of self-support because he is mentally or physically defective, but only with respect to expenses incurred in a period during which such incapacity exists.

Husbands whose wives are incapacitated

Paragraph (3) of section 214(b) imposes limitations on the new deduction allowable to a husband whose wife is incapacitated during the taxable year. In such case a deduction may be allowed for child care expenses only if the taxpayer files a joint return with his wife. Further, the deduction otherwise allowable is reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $4,500. However, paragraph (3) provides that the limitations do not apply to expenses incurred while the taxpayer's wife is institutionalized for a period of at least 90 consecutive days (whether or not within 1 taxable year) or a shorter period if terminated by her death. (See sec. 214(c) for special rule applicable where a wife is incapacitated or is institutionalized and sec. 214(d) (3) and (4) for definitions of the terms "incapacitated wife" and "institutionalized wife.")

The application of the rules contained in paragraphs (1), (2), and (3) of section 214(b) is illustrated by the following examples:

Example (1).—H and W are married at all times during 1964. They have two dependent children aged 6 and 10 years. As a result of an accident, H incurs injuries which render him incapable of self-support from January 1, 1964, to March 1, 1964. Their adjusted gross income for 1964 is $4,600 and they file a joint return. W incurs and pays $70 a month for child care expenses during 1964. The total allowable deduction in this case is $640, computed as follows: the $700 incurred while H was capable of self-support is reduced to $600 (the maximum deduction allowable for any period during which a husband is capable of self-support) and the $600 is then reduced to $500 (because of the $100 excess of H and W's adjusted gross income over $4,500); to this $500 is added $140 for the expenses incurred while H was incapable of self-support.

Example (2).—H and W are married at all times during 1964. They have three dependent children aged 2, 4, and 6. On February 1, 1964, W becomes incapacitated and remains unable to care for herself until April 1, 1964, at which time W is admitted to a hospital for medical treatment. W remains in the hospital continuously until August 1, 1964, at which time she returns home. On

August 1, 1964, and for the remainder of 1964, W is capable of caring for herself. H incurs and pays $80 a month for child care expenses from February 1, 1964, to August 1, 1964. H and W's adjusted gross income for 1964 is $4,600 and they file a joint return. The total allowable deduction in this case is $380, computed as follows: the $160 incurred during February and March while W was incapacitated but not institutionalized is reduced to $60 (because of the $100 excess of the adjusted gross income over $4,500); to this $60 is added $320 for the child care expenses incurred while W was institutionalized.

Certain payments not taken into account

Paragraph (4) of section 214(b) continues the provision of existing law that no deduction is allowed for any amount paid to an individual with respect to whom the taxpayer is allowed for his taxable year a deduction under section 151 of the code (relating to deductions for personal exemptions).

(c) *Special rule where wife is incapacitated or institutionalized.*—Section 214(c) limits the new deduction allowable under section 214(a) to a husband whose wife is incapacitated or is institutionalized. The deduction is limited to those child care expenses which are incurred while his wife is incapacitated (as defined in sec. 214(d)(3)) or institutionalized (as defined in sec. 214(d)(4)), as the case may be, for a period of at least 90 consecutive days (whether or not within 1 taxable year) or a shorter period if terminated by her death.

A wife who is institutionalized, within the meaning of section 214 (d)(4), for any period of time (whether or not for 90 consecutive days), is, pursuant to the provisions of section 214(d)(3), considered to be incapacitated during that period. Thus, if, during the entire month of March, a taxpayer's wife is incapable of caring for herself because mentally or physically defective and, during the entire period April 1 through June 30 of the same year, is an inpatient in a hospital for the purpose of receiving medical care or treatment, such wife is considered to be incapacitated during the entire period March 1 through June 30. In addition the wife is considered to be institutionalized for a period of at least 90 consecutive days (April 1 through June 30). Thus, child care expenses incurred during March are deductible, subject to the limitations of section 214(b)(3) ($4,500 income limitation and joint return requirement), and child care expenses incurred during April, May, and June are deductible without regard to such limitations. However, if the wife had been institutionalized only from April 1 to May 30, the wife is considered to be incapacitated for a 90-day period but is not considered institutionalized for a 90-day period. Thus, child care expenses incurred during March, April, and May are deductible but are subject to the limitations of section 214(b)(3).

Computation of 90-day period

For purposes of section 214(c), different periods of incapacity separated by a period of time cannot be combined to satisfy the requirement that a wife be incapacitated for 90 consecutive days. Similarly, in the case of an institutionalized wife, separated periods of institutionalization cannot be combined. However, the running of a period of institutionalization includes brief absences from the institution (such as on weekends) and is not interrupted by transfers from one institution to another.

Since a wife who is institutionalized is considered to be incapacitated, the period during which a wife is institutionalized is added to a consecutive period during which she is incapacitated for purposes of determining whether the wife was incapacitated for a period of 90 consecutive days. Thus, the 90-consecutive-day requirement is met where a wife remains at home unable to care for herself because of a physical or mental defect for 60 consecutive days and immediately thereafter enters an institution where she continuously remains for an additional 30 days receiving medical care or treatment, whether or not she is able to care for herself during such 30 days.

90-day period not occurring in 1 taxable year

The 90-consecutive-day period need not occur in 1 taxable year. If part of the period occurs in 1 taxable year and the remainder in the succeeding taxable year, a deduction is allowable (if all other conditions of sec. 214 are satisfied) for the child care expenses incurred during the part of the period occurring in each such year. If the taxpayer's wife is institutionalized or incapacitated at the end of the taxable year which immediately precedes the first taxable year of the taxpayer beginning after December 31, 1963, and she continues to be institutionalized or incapacitated into such first taxable year, then her period of institutionalization or incapacity occurring in the preceding taxable year may be counted in satisfying the 90-day requirement.

(*d*) *Definitions.*—Section 214(d) retains, with the modification discussed below, the existing definitions of the terms "dependent" and "widower" and the special rule relating to the status of a woman who is legally separated or divorced or who has been deserted by her spouse. Definitions of the terms "incapacitated wife" and "institutionalized wife" are added (in new pars. (3) and (4)).

Dependent

Paragraph (1)(A) of section 214(d) provides that the term "dependent" means a person with respect to whom the taxpayer is entitled to a deduction for an exemption under section 151(e)(1) of the code who (1) has not attained the age of 13 years and who (within the meaning of sec. 152) is a son, stepson, daughter, or stepdaughter of the taxpayer or (2) regardless of age, is physically or mentally incapable of caring for himself. The amendment made by the bill substitutes an age limit of up to 13 years for the age limit of up to 12 years contained in existing law.

Incapacitated wife

The new paragraph (3) of section 214(d) provides that a wife is considered incapacitated only while she is incapable of caring for herself because of a physical or mental defect or while she is institutionalized as defined in paragraph (4).

Institutionalized wife

The new paragraph (4) of section 214(d) provides that a wife is considered institutionalized only while she is, for the purpose of receiving medical care or treatment, an inpatient, resident, or inmate of a public or private hospital, sanitarium, or other similar institution. A wife who resides at a hospital, sanitarium, or other similar institution by reason of her employment is not institutionalized.

SECTION 211. CARE OF DEPENDENTS (Continued)

(*b*) *Effective date.*—Subsection (b) of section 211 of the bill provides that the amendments made by subsection (a) of such section apply to taxable years beginning after December 31, 1963.

SECTION 212. MOVING EXPENSES

(*a*) *Deduction allowed for moving expenses.*—Subsection (a)(1) of section 212 of the bill amends part VII of subchapter B of chapter 1 of the code (relating to additional itemized deductions for individuals) by redesignating section 217 as section 219 and inserting a new section 217.

SECTION 217. MOVING EXPENSES

(*a*) *Deduction allowed.*—The new section 217(a) allows, subject to certain conditions, a deduction for "moving expenses" paid or incurred by the taxpayer during the taxable year. To be deductible, the moving expenses must be paid or incurred in connection with the commencement of work by the taxpayer as an employee at a new principal place of work. Moving expenses incurred in relocating the taxpayer's residence to a location which is further from his new principal place of work than was his former residence are not generally incurred in connection with such commencement of work.

(*b*) *Definition of moving expenses.*—Section 217(b) defines the term "moving expenses" to mean only the reasonable expenses (1) of moving household goods and personal effects from the taxpayer's former residence to his new residence, and (2) of traveling from the taxpayer's former residence to his new place of residence. The term includes such expenses of the taxpayer and of members of the taxpayer's household who have both the taxpayer's former residence and his new residence as their principal place of abode.

Reasonable expenses

The term "moving expenses" includes only those expenses which are reasonable under the circumstances of the particular move. Generally, moving expenses are reasonable only if they are paid or incurred for movement by the shortest and most direct route available from the taxpayer's former residence to his new residence by the conventional mode or modes of transportation actually used. Expenses paid or incurred in excess of a reasonable amount are not deductible.

Expenses of moving household goods and personal effects

Expenses of moving household goods and personal effects include expenses of transporting such goods and effects from the taxpayer's former residence to his new residence, and expenses of packing, crating, and in-transit storage of such goods and effects. Examples of items not deductible as moving expenses include, but are not limited to, costs incurred in the acquisition of property, costs incurred and losses sustained in the disposition of property, penalties for breaking leases, mortgage penalties, expenses of refitting rugs or draperies, tuition fees, and similar items.

Expenses of traveling

Expenses of traveling include the cost of transportation and of meals and lodging en route on one trip from the taxpayer's former

residence to his new place of residence. Expenses of traveling do not include living expenses following the date of arrival at the new place of residence, living expenses preceding the date of departure for the new place of residence, expenses of house or apartment hunting, or expenses of trips for purposes of selling property.

Residence

The term "former residence" refers to the taxpayer's principal residence before his departure for his new principal place of work. The term "new residence" refers to the taxpayer's principal residence at his new principal place of work. Thus neither term has application to other residences maintained by the taxpayer, such as a summer beach cottage. The term "new place of residence" includes the metropolitan area within which the taxpayer's new residence is located.

(c) *Conditions for allowance.*—Section 217(c) provides certain conditions which must be satisfied for a deduction to be allowed under section 217(a).

Minimum distance

Under section 217(c)(1), no deduction is allowed unless the distance between the taxpayer's new principal place of work and his former residence exceeds by at least 20 miles the distance between his former principal place of work and such former residence. If the taxpayer had no former principal place of work, no deduction is allowed unless the distance between his new principal place of work and his former residence is at least 20 miles. For purposes of measuring distances under section 217(c)(1) all computations are to be made on the basis of a straight-line measurement.

A taxpayer's "principal place of work" is determined with reference to his principal employment, if he has more than one employment. Usually, a taxpayer's principal place of work is the place at which he spends most of his working time. However, a taxpayer may have a principal place of work even if there is no one place at which he spends a substantial portion of his working time. In such case, the taxpayer's principal place of work is the place at which his business activities are centered—for example, because he reports there for work. Individuals who are seeking full-time employment for the first time (for example, recent high school or college graduates), or individuals who are reentering the labor force after a substantial period of unemployment or part-time employment, have no former principal place of work.

Minimum period of employment

Under section 217(c)(2) no deduction is allowed unless, during the 12-month period immediately following the taxpayer's arrival in the general location of his new principal place of work, the taxpayer is a full-time employee, in such general location, during at least 39 weeks. It is not necessary that the taxpayer remain in the employ of the same employer for 39 weeks, but only that he be employed in the same general location during such period. The "general location" of the new principal place of work refers to the area within which an individual might reasonably be expected to commute to such place of work.

The 12-month period and the 39-week period are to be measured from the date of the taxpayer's arrival in the general location of his

new principal place of work. Generally, the taxpayer's date of arrival is the date of the termination of the trip immediately following which the taxpayer starts to work at his new principal place of work on a regular basis, regardless of the date on which the taxpayer's family arrives.

Only a week during which the taxpayer is a full-time employee qualifies as a week of work. Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographical area in which the taxpayer works. In the case of occupations where employment is on a seasonal basis, weeks occurring in the off season where no work is required or available may be counted as weeks of full-time work only if the employee's contract or agreement of employment covers the off-season period and the off-season period is less than 6 months.

(*d*) *Rules for application of subsection* (*c*)(*2*).—Section 217(d) provides special rules for the application of section 217(c)(2).

Inapplicability of 39-week test to reimbursed expenses

Paragraph (1) of section 217(d) provides that the 39-week employment condition of section 217(c)(2) does not apply to any item to the extent that the taxpayer receives reimbursement or other allowance from his employer for such item. A reimbursement or other allowance to an employee for expenses of moving, in the absence of a specific allocation by the employer, is allocated first to items deductible under section 217(a) and then (if a balance remains) to items not so deductible.

Election of deduction before 39-week test is satisfied

Paragraph (2) of section 217(d) provides a special rule which applies in those cases where a taxpayer paid or incurred, in a particular taxable year, moving expenses which would be deductible in that taxable year except that the 39-week employment condition of section 217(c)(2) has not been satisfied before the time prescribed by law (including extensions thereof) for filing the return for such taxable year. If at such time there remains unexpired a sufficient portion of the 12-month period so that it is still possible for the taxpayer to satisfy the 39-week requirement, then the taxpayer may elect to claim a deduction for such expenses on the return for such taxable year filed within the time prescribed by law (including extensions thereof).

In the event that a taxpayer has not claimed a deduction for moving expenses on the return for the taxable year in which such expenses were paid or incurred, and the 39-week employment condition (as well as all other requirements of sec. 217) is subsequently satisfied, then the taxpayer may file an amended return for the taxable year in which such moving expenses were paid or incurred on which he may claim a deduction under section 217.

Recapture of deduction where 39-week test is not met

Paragraph (3) of section 217(d) provides a special rule which applies in cases where the taxpayer has deducted moving expenses under the election of paragraph (2), and the 39-week test is not satisfied by the close of the taxable year immediately following the taxable year in which the expenses were deducted. Paragraph (3) provides that in such cases an amount equal to the expenses which were deducted must be included in the taxpayer's gross income for the taxable

year immediately following the taxable year in which the expenses were deducted.

(*e*) *Disallowance of deduction with respect to reimbursements not included in gross income.*—Section 217(e) provides that no deduction is allowed under section 217 for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item unless the amount of such reimbursement or other expense allowance is included in his gross income. Thus if an employee has claimed a deduction for moving expenses and subsequently receives a reimbursement for such expenses which he does not include in his gross income, then he must file an amended return for the taxable year in which the deduction was claimed. However, section 217 does not permit any employee to exclude from gross income any reimbursement or other allowance not properly excludable under present law.

(*f*) *Regulations.*—Section 217(f) provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as may be necessary to carry out the purposes of section 217.

SECTION 212. MOVING EXPENSES (Continued)

Subsection (a)(2) of section 212 of the bill amends the table of sections for part VII of subchapter B of chapter 1 of the code to reflect the redesignation of section 217 as section 219 and the insertion of the new sections 217 and 218 added by sections 212(a)(1) and 203(b) of the bill.

(*b*) *Adjusted gross income.*—Subsection (b) of section 212 of the bill amends section 62 of the code (defining adjusted gross income) by inserting a new paragraph (8). This new paragraph provides that, in computing adjusted gross income, gross income is to be reduced by the deduction allowed by the new section 217 for moving expenses.

(*c*) *Withholding.*—Subsection (c) of section 212 of the bill amends section 3401(a) of the code (relating to definition of wages) by adding a new paragraph (15) at the end thereof. Under this new paragraph, the term "wages" (for purposes of withholding of income tax at source on wages) does not include remuneration paid to or on behalf of an employee if (and to the extent that) at the time of the payment of such remuneration it is reasonable to believe that a corresponding deduction is allowable under section 217.

(*d*) *Effective dates.*—Subsection (d) of section 212 of the bill provides that the amendments made by subsections (a) and (b) of such section apply to moving expenses incurred after December 31, 1963, in taxable years ending after such date, and that the amendment made by subsection (c) applies with respect to remuneration paid after December 31, 1963.

SECTION 213. INTEREST ON LOANS INCURRED TO PURCHASE CERTAIN INSURANCE AND ANNUITY CONTRACTS

Section 213 of the bill amends section 264 of the code to provide that, under certain circumstances, no deduction is allowed for interest on loans incurred or continued to purchase or carry certain life insurance, endowment, or annuity contracts (other than single-

premium contracts or contracts which are treated as single-premium contracts for purposes of section 264).

(*a*) *Disallowance of interest deduction.*—Subsection (a)(1) of section 213 of the bill amends section 264(a) of the code by adding a new paragraph (3). The new paragraph (3) provides that, except as provided in section 264(c) (which is added by subsec. (b) of this section of the bill), no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single-premium contract or a contract treated as a single-premium contract) pursuant to a plan of purchase which contemplates systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

Amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single-premium life insurance, endowment, or annuity contract (including a contract treated as a single-premium contract) are excluded from the provision of the new paragraph (3). The deductibility of these amounts is governed by the provisions of sections 264(a)(2) and 264(b).

In order for a deduction to be disallowed under the new paragraph (3) of section 264(a) for amounts paid or accrued on indebtedness, such indebtedness must be incurred or continued as part of a plan to systematically borrow (either directly or indirectly) part or all of the increases in the cash value of a contract in order to purchase the contract (that is, to pay part or all of the premiums thereon). Thus it would not apply to disallow a deduction in the case of irregular borrowing against the cash value of a contract. However, the mere fact that the taxpayer does not borrow against the increase in the cash value to pay a premium for a particular year does not preclude the new paragraph (3) from applying if, under the facts and circumstances, a regular pattern of borrowing to pay premiums exists. The new paragraph (3) may apply even though the plan does not involve the systematic borrowing of part or all of the increases in the cash value to pay the premiums over the entire life of the contract so long as the plan contemplates the systematic borrowing of part or all of the increases in the cash value to pay premiums for a substantial number of years. The new paragraph (3) may apply even though the plan of purchase described therein does not exist at the time the contract is entered into. However, under the exception included in the new section 264(c)(1), the plan of purchase must come into existence before the fourth annual premium due under the contract is paid or, if there is a substantial increase in the premiums on the contract, before the fourth such increased premium is paid.

The new paragraph (3) applies both in the case of direct and indirect borrowing of part or all of the increases in the cash value of a contract.

Subsection (a)(2) of section 213 of the bill adds a new sentence, at the end of section 264(a) of the code, which provides that the new paragraph (3) applies only in respect of contracts purchased after August 6, 1963. The new paragraph (3) does not apply with respect to a contract purchased before August 7, 1963, even though there is a substantial increase in the premiums under such contract after such date.

(*b*) *Exceptions.*—Subsection (b) of section 213 of the bill amends section 264 of the code by adding at the end thereof a new subsection

(c) which provides four exceptions to the general rule in the new paragraph (3) of section 264(a).

Paragraph (1) of the new subsection (c) provides that paragraph (3) of section 264(a) does not apply to any amount paid or accrued on indebtedness incurred or continued as part of a plan referred to in such paragraph (3) if no part of four of the annual premiums due during the 7-year period, beginning with the date the first premium on the contract to which the plan relates was paid, is paid under such plan by means of indebtedness. For this purpose, if the premiums on a contract are payable other than on an annual basis (as, for example, if they are payable monthly), the term "annual premium" means the aggregate of the premiums due for the year. Under this exception the new paragraph (3) of section 264(a) is not applicable unless some part of at least four of the first seven annual premiums due on the contract is paid under the plan by means of indebtedness. However, if any part of four of the first seven annual premiums is paid under the plan by means of indebtedness and the new paragraph (3) otherwise applies, then any deductions claimed by the taxpayer for interest paid or accrued on the loans incurred to pay these premiums will be disallowed if the taxable years involved are not closed by reason of the statute of limitations or other rule of law. The new subsection (c) provides that, for purposes of applying the exception in paragraph (1) thereof, if there is a substantial increase in the premiums on a contract, a new 7-year period with respect to such contract commences on the date the first such increased premium is paid.

Paragraph (2) of the new subsection (c) provides that paragraph (3) of section 264(a) does not apply to any amount paid or accrued by a person during a taxable year on indebtedness if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to such paragraph (2)) no deduction would be allowable by reason of paragraph (3) of section 264(a) does not exceed $100. Thus, even though a taxpayer has entered into one or more plans referred to in the new paragraph (3) of section 264(a), his interest deduction for a taxable year will nevertheless not be disallowed under such paragraph if the total interest subject to such paragraph for such taxable year does not exceed $100.

Paragraph (3) of the new subsection (c) provides that the new paragraph (3) of section 264(a) does not apply to any amount paid or accrued by a person on indebtedness incurred because of an unforeseen substantial loss of income or an unforeseen substantial increase in his financial obligations. Thus, for example, the new paragraph (3) of section 264(a) does not operate to disallow a deduction for interest paid on a loan against the cash value of a contract if such loan was incurred by the taxpayer because of unexpected medical expenses or because of an unforeseen layoff from his job (whether or not the loan is used to pay a premium on the contract).

Paragraph (4) of the new subsection (c) makes it clear that the new paragraph (3) of section 264(a) does not apply to any amount paid or accrued on indebtedness incurred in connection with the taxpayer's trade or business. Thus, if the taxpayer pledges his insurance contract as part of the collateral for a loan to finance capital improvements for his business, no part of the interest on such loan would be disallowed as a deduction under the new paragraph (3) of section 264(a).

(*c*) *Effective date.*—Subsection (c) of section 213 of the bill provides that the amendments made by such section apply with respect to amounts paid or accrued in taxable years beginning after December 31, 1963.

SECTION 214. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS

(*a*) *In general.*—Subsection (a) of section 214 of the bill revises part II of subchapter D of chapter 1 of the code, which deals with employee stock options. The revised part II consists of an amended section 421 of the code and new sections 422, 423, 424, and 425. Section 421 as amended by the bill contains general rules applicable to options described in sections 422, 423, and 424. The new sections 422 and 423 relate to qualified stock options and employee stock purchase plans, respectively, and contain new rules to be applied in determining whether the transfer of a share of stock to an individual pursuant to his exercise of a stock option qualifies for tax treatment similar to that presently provided by section 421(a) of the code. The new section 424 continues the present treatment for restricted stock options granted before the effective date of the new rules. The new section 425 contains definitions and special rules common to the other provisions of the revised part II. The new sections, and the respects in which their provisions differ from the provisions of the existing section 421, are as follows:

SECTION 421. GENERAL RULES

(*a*) *Effect of qualifying transfer.*—Section 421(a), as amended by this section of the bill, contains the rules relating to the tax treatment of an individual receiving a share of stock in a transfer pursuant to the exercise of an option with respect to which the requirements of section 422(a) (relating to qualified stock options), 423(a) (relating to employee stock purchase plans), or 424(a) (relating to restricted stock options) are met. These rules are similar to those contained in the existing section 421(a) (1), (2), and (3), and provide that—

(1) except as provided in section 422(c)(1), no income results at the time of the transfer of the share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 of the code (relating to trade or business expenses) is allowable at any time to the employer corporation or a parent or subsidiary of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option is considered as received by any of such corporations for the share so transferred.

(*b*) *Effect of disqualifying disposition.*—Section 421(b) as amended contains rules relating to the tax effects of an individual's failure to satisfy the holding period requirement of section 422(a)(1), 423 (a)(1), or 424(a)(1) with respect to a share of stock acquired pursuant to the exercise of an option with respect to which the other re-

quirements of section 422(a), 423(a), or 424(a) are met. These rules are similar in effect to those contained in the existing section 421(f), and provide that any increase in the income of the individual or deduction from the income of his employer corporation, for the taxable year in which the exercise occurred attributable to the disposition, is treated as an increase in income or deduction from income in the taxable year of the individual or his employer corporation in which such disposition occurred.

(c) *Exercise by estate.*—Section 421(c) as amended provides the same substantive rules as the existing section 421(d)(6) governing the exercise of an option to which part II of subchapter D of chapter 1 applies after the death of the employee by his estate or a person who acquired the right to exercise such option by bequest, inheritance, or by reason of the death of the decedent.

General rule

Paragraph (1) of section 421(c) provides that, as a general rule, the provisions of section 421(a) apply to the exercise of an option by an employee's estate to the same extent as if the option had been exercised by the decedent, except that—

(1) the holding period and employment requirements of sections 422(a), 423(a), and 424(a) do not apply, and

(2) any transfer by the estate of stock acquired is considered a disposition of such stock for purposes of sections 423(c) and 424(c).

Deduction for estate tax

Paragraph (2) of section 421(c) provides that the employee's estate or heir is entitled to a deduction in the amount of the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the option. The deduction is determined under section 691(c) of the code as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) were an amount included in gross income under section 691 in respect of such item of gross income.

Basis of shares acquired

Paragraph (3) of section 421(c) provides certain basis rules which apply in the case of stock acquired by the estate or heir pursuant to the exercise of an option to which the revised part II applies.

Subparagraph (A) of section 421(c)(3) provides that, as a general rule, the basis of any share of stock acquired pursuant to the exercise of such an option is to include an allocable portion of the basis of the option in addition to the amount paid for the share. However, as an exception to this general rule, this subparagraph further provides that the basis is to be reduced by the excess of the amount that would have been includible in the employee's gross income at the time of his death under section 422(c)(1), 423(c), or 424(c)(1) (determined as if the option had been exercised on the date of his death and the stock so acquired was held at such time) over the amount includible in gross income to the estate or heir under such section.

Subparagraph (B) of section 421(c)(3) provides that the last sentences of sections 422(c)(1), 423(c), and 424(c)(1) apply only to the

extent that the amount includible in gross income exceeds the basis for the option attributable to the share.

SECTION 422. QUALIFIED STOCK OPTIONS

(*a*) *In general.*—The new section 422(a) provides new holding period and employment requirements which must be satisfied if an individual receiving a qualified stock option is to obtain the special tax treatment afforded by section 421(a) as amended. Generally, under present law, a share of stock transferred to an individual pursuant to his exercise of a restricted stock option must not be disposed of within 2 years from the date of the granting of the option nor within 6 months after the transfer of the share to the individual if the individual is to obtain the special tax treatment provided by section 421(a). As an additional prerequisite to the special tax treatment provided by the existing section 421(a), the individual is required to be an employee of the grantor corporation, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which section 425(a) (relating to corporate reorganizations, liquidations, etc.) applies at the time of the granting of the option and at the time the option is exercised, or within the 3-month period preceding the date of exercise. In comparison, the new section 422(a) requires stock acquired pursuant to the exercise of a qualified stock option (as defined in section 422(b)) to be held for at least 3 years after the stock is transferred to the individual and requires that the individual be an employee of a corporation described in the preceding sentence at all times beginning with the date the option is granted and ending on the day 3 months before the option is exercised if the special treatment afforded by section 421(a) as amended by the bill is to be obtained. Thus, section 422(a) provides that section 421(a) applies with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option (as defined in sec. 422(b)) if—

(1) no disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share to the individual, and

(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) (relating to corporate reorganizations, liquidations, etc.) applies.

For example, if an individual is granted a qualified stock option to purchase stock in his employer corporation on January 2, 1964, and such individual continues to be an employee of such corporation until he terminates his employment on June 6, 1965, he may exercise his option at any time from the date the option was granted to him through September 6, 1965. Assuming that such individual exercises his option on September 6, 1965, and that the stock is transferred to him on September 10, 1965, he must not dispose of the stock before September 11, 1968, if he is to qualify for the special tax treatment afforded by section 421(a).

(*b*) *Qualified stock option.*—The new section 422(b) defines the term "qualified stock option" for purposes of the revised part II as an option granted to an individual after June 11, 1963 (other than a restricted stock option granted pursuant to a contract described in sec. 424(c)(4)(A)), for any reason connected with his employment by the corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if the requirements of paragraphs (1) through (7) of section 422(b) are met.

Stockholder approval

Paragraph (1) of section 422(b) requires that the option be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. The plan so approved must indicate the aggregate number of shares which may be issued under options, and the employees, or class of employees, eligible to receive options. A plan will be considered as indicating the aggregate number of shares which may be issued under options although the number of shares that may be optioned may be increased to reflect changes in the capitalization of the company, such as stock splits, etc. A plan may satisfy the requirements of paragraph (1) although the board of directors or another group may be given the authority to select the employees to whom options are granted and the authority to decide upon the number of shares to be optioned to each employee. A plan is adopted within the meaning of paragraph (1) when all the conditions (other than stockholder approval) precedent to the granting of options under the plan have been completed by the corporation.

Period for granting options

Paragraph (2) of section 422(b) provides that a qualified stock option must be granted within 10 years from the date the plan is adopted, or the date the plan is approved by the stockholders, whichever is earlier.

Period for exercising options

Paragraph (3) of section 422(b) provides that a qualified stock option by its terms must not be exercisable after the expiration of 5 years from the date the option is granted.

Option price

Paragraph (4) of section 422(b) provides that the option price, except as provided in section 422(c)(1) (relating to exercise of option when price is less than value of stock), must not be less than the fair market value of the stock at the time the option is granted.

Prior outstanding options

Paragraph (5) of section 422(b) provides that the new option by its terms must not be exercisable while there is outstanding (within the meaning of sec. 422(c)(2), relating to certain options treated as outstanding) any qualified or restricted stock option which was granted, before the granting of the new option, to the individual to purchase stock in the employer corporation or in a corporation which (at the time of the granting of such option) is its parent or subsidiary corporation, or in a predecessor corporation of any of such corporations. Thus, when a qualified stock option is granted to an individual with

respect to the stock of his employer corporation, or a parent or subsidiary corporation of such corporation, and a qualified or restricted stock option was previously granted to such individual with respect to the stock of any of such corporations, the qualified or restricted option previously granted to the individual must lapse or be exercised by the individual before the qualified option currently being granted to such individual may be exercised. The same rule applies to options granted by a predecessor corporation of any of such corporations. For example, if the present employer corporation or its parent or subsidiary corporation has succeeded to the business of a corporation by reason of a transaction described in section 425(a), a qualified or restricted stock option granted by the predecessor corporation prior to such transaction must lapse or be exercised by the individual before a qualified option currently being granted to such individual may be exercised. If several qualified stock options were previously granted to the individual, the options must be exercisable only in the order in which they were granted, with the first option granted being the first exercisable, regardless of which of the corporations' stock is subject to the option. The rule of paragraph (5) applies only with respect to qualified and restricted stock options which are outstanding (within the meaning of sec. 422(c)(2)) at the time the new qualified stock option is granted. Paragraph (5) does not apply with respect to options which are not qualified or restricted stock options.

Restriction on transferability

Paragraph (6) of section 422(b) is identical to the existing section 421(d)(1)(B) and provides that the option by its terms must not be transferable by the individual otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him.

Restriction on ownership

Paragraph (7) of section 422(b) provides that the individual receiving the option, immediately after such option is granted, must not own stock possessing more than 5 percent of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation; except that if the equity capital of such corporation or corporations (determined at the time the option is granted) is less than $2 million, then, for purposes of applying the limitation of paragraph (7), there is added to such 5 percent the percentage (not higher than 5 percent) which bears the same ratio to 5 percent as the difference between the equity capital and $2 million bears to $1 million. Under no circumstances may the additional percentage exceed 5 percent, nor may the total percentage limitation of section 422(b)(7) exceed 10 percent.

The operation of the percentage limitation of paragraph (7) is illustrated by the following example:

Example.—E is an employee of the P Corp. P owns 60 percent in value of the stock of the S Corp., and P Corp. and S Corp. have combined equity capital (as defined by sec. 422(c)(3)(A)(ii)) of $1,600,000. Since the equity capital of P and S is less than $2 million, there may be added to the 5-percent limitation the additional percentage which bears the same proportion to 5 percent as the difference between the equity capital and $2 million ($2 million minus $1,600,000, or $400,000)

bears to $1 million. Accordingly, there may be added to the 5-percent limitation of section 422(b)(7) an additional 2 percent ($400,000 is to $1 million as 2 percent is to 5 percent) resulting in a limitation of 7 percent (5 percent plus 2 percent) for purposes of section 422(b)(7). Thus, an option which otherwise meets the requirements of section 422(b) and which is granted to E by P or S to purchase the stock of either of such corporations will meet the requirement of section 422(b)(7) to the extent that, immediately after such option is granted, E will not own stock (within the meaning of sec. 422(c)(3)) in either P or S possessing more than 7 percent of the total combined voting power or value of all classes of stock of either of such corporations. If, at the time the option was granted, E owned stock possessing more than 7 percent of the total combined voting power or value of either P or S, the option could not qualify as a qualified stock option, irrespective of which corporation's stock was the subject of the option.

For the definition of the term "equity capital" and other special rules relating to the application of section 422(b)(7), see section 422(c)(3).

(*c*) *Special rules.*—The new section 422(c) provides special rules which are to be applied in connection with the requirements of section 422 (a) and (b).

Exercise of option when price is less than value of stock

Paragraph (1) of section 422(c) provides that, if a share of stock is transferred pursuant to the exercise by an individual of an option which fails to qualify as a qualified stock option under section 422(b) because there was a failure to meet the option price requirement of section 422(b)(4), the requirement of section 422(b)(4) will be considered to have been met if there was an attempt made in good faith to meet such requirement. However there is includible as compensation in the individual's gross income, for the taxable year in which the option is exercised, an amount equal to the lesser of—

(1) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

(2) the difference between the option price and the fair market value of the share at the time of such exercise.

Whether there was a good-faith attempt to set the option price at 100 percent of the fair market value of the stock, subject to the option at the time the option was granted, depends on the facts and circumstances surrounding the case. For example, if it is shown that the fair market value of the stock was established by using an average of the fair market values set forth in the opinions of completely independent and well-qualified experts, such a showing establishes that there was an attempt in good faith to meet the requirement of section 422(b)(4). In any case where an amount is included in gross income by reason of section 422(c)(1), the basis of the share acquired is increased by an amount equal to the amount included in gross income in the taxable year in which the exercise occurred.

Certain options treated as outstanding

Paragraph (2) of section 422(c) provides that, in applying the rule of section 422(b)(5) (relating to prior outstanding options), any restricted stock option which is not terminated before January 1, 1965, and any qualified stock option, will be treated as outstanding

until such option is exercised in full or expires solely by reason of the lapse of time. Restricted stock options terminated before January 1, 1965, will not be treated as outstanding for purposes of section 422 (b)(5), irrespective of the reason for which such option was terminated. On the other hand, if any qualified stock option (and any restricted stock option not terminated before January 1, 1965) which was not exercised in full is terminated by cancellation, rescission, or any other form of termination, or by the occurrence of any condition (other than the lapse of time), such option is treated as outstanding until it would have lapsed solely by reason of the passage of the time during which the option, according to its terms when granted, could be exercised. A restricted stock option which is modified (within the meaning of sec. 425(h)(3)) after December 31, 1964, and a qualified stock option which is modified at any time, is treated as outstanding according to its orginal terms. For example, if a qualified stock option has an option price of $100 when granted, and if the option price is reduced to $75, the option is treated as an outstanding qualified stock option with an option price of $100 for purposes of section 422 (b)(5). A restricted or qualified stock option issued or assumed by a corporation in a corporate reorganization or liquidation to which section 425(a) applies is treated as outstanding to the same extent and in the same manner as the restricted or qualified stock option previously held by the individual and replaced or assumed in the reorganization or liquidation but, in such a case, the restricted or qualified stock option previously held by the individual is not treated as outstanding. If section 425(a) does not apply to a corporate reorganization or liquidation, a qualified or restricted stock option held by the individual before such corporate reorganization or liquidation is treated as outstanding according to its original terms irrespective of whether the effect of the corporate reorganization or liquidation is to terminate such an option.

An exception to the general rule of paragraph (2) applies in the case of a restricted stock option granted before June 12, 1963. Such an option is not treated as outstanding before the first day on which such option is exercisable under its terms. If an option is exercisable in installments, each installment is treated as a separate option for purposes of this rule. For example, if a restricted stock option was granted in 1960, and if the terms of such option provide that it is to be exercised in five equal installments during the calendar years 1961, 1962, 1963, 1964, and 1965, respectively, the installments that are exercisable in the years 1964 and 1965 are not treated as outstanding in 1963. Further, the installments that are exercisable in 1964 and 1965 are treated as outstanding as of the first day that each such installment becomes exercisable in such years under the terms of the option.

Options granted to certain shareholders

Paragraph (3) of section 422(c) provides special rules for the application of section 422(b)(7). Thus, subparagraph (A) of section 422(c)(3) defines the term "equity capital" to mean—

(1) in the case of one corporation, the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders), and

(2) in the case of a group of corporations consisting of a parent and its subsidiary corporations, the sum of the equity capital of each of such corporations adjusted, under regulations prescribed by the Secretary of the Treasury or his delegate, to eliminate the effect of intercorporate ownership or transactions among such corporations.

Subparagraph (B) of section 422(c)(3) provides that the rules of section 425(d) (relating to attribution of stock ownership) apply in determining the stock ownership of the individual. These are the same rules as are contained in the existing section 421(d)(1)(C).

Subparagraph (C) of section 422(c)(3) provides that stock which an individual may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by sec. 421(a)) are to be treated as stock owned by the individual. For purposes of such subparagraph, an option is outstanding although under its terms it may only be exercised in installments or after the expiration of a fixed period of time. However, the rules of section 422(c)(2) which are applied in determining whether an option is outstanding for purposes of section 422(b)(5) do not apply for purposes of section 422(b)(7) and such subparagraph (C).

Section 422(c)(3) further provides that an option which permits an individual to purchase stock in excess of the limitation of section 422(b)(7) is to be treated as meeting the percentage limitation of section 422(b)(7) to the extent that the individual could, if the option were exercised in full at the time of grant, purchase stock under the option without exceeding such limitation. In determining which portion of such an option meets the requirement of section 422(b)(7), that portion which is first exercised is deemed to be the portion which meets the requirement of such subsection.

Certain disqualifying dispositions where amount realized is less than value at exercise

Paragraph (4) of section 422(c) provides that if an individual who has acquired a share of stock by the exercise of a qualified stock option disposes of such share within 3 years of the transfer of such share to him and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then the amount includible in the gross income of such individual, and deductible from the income of his employer corporation, as compensation attributable to the exercise of such option cannot exceed the excess, if any, of the amount realized on such sale or exchange over the amount paid for such share. For purposes of paragraph (4), the amount paid for a share of stock is the amount paid or to be paid for such share. The effect of such paragraph is to place a ceiling on the amount of compensation resulting from certain disqualifying dispositions of stock acquired pursuant to an individual's exercise of a qualified stock option. The ceiling provided by such paragraph only applies if the disqualifying disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized. Thus, the ceiling does not apply when the disqualifying disposition is a sale described in section 1091 of the code (relating to loss from wash sales of stock or securities), a gift, or a sale described in section 267(a)(1) of the code (relating to sales between related persons), since no loss could be recognized with

respect to any such transaction. The operation of section 422(c)(4) is illustrated by the following examples:

Example (1).—E is granted by his employer, Z Corporation, a qualified stock option which permits him to purchase the Z Corporation stock for $100 a share. The fair market value of such stock is $100 at the time the option is granted. E exercises such option and buys one share of the stock when the fair market value of the stock is $200 per share. E makes a disqualifying disposition of such share by selling such share for $250 less than 3 years after its transfer to him. Since the amount realized on such sale exceeds the fair market value of the share at the date of exercise, section 422(c)(4) has no effect in this situation. Accordingly, E must include in his gross income for the taxable year in which the sale occurred $100 as compensation ($200, the fair market value of the share at the date of exercise, less $100, the price paid for the stock) and $50 as capital gain ($250, the amount realized from the sale, less his basis of $200, the $100 paid for the stock plus the $100 increase in basis as a result of including such amount in gross income). For its taxable year in which the disqualifying disposition occurs, Z is allowed a deduction of $100 for compensation to E attributable to his exercise of the qualified stock option.

Example (2).—The facts are the same as in example (1), except that E sells the share for $150. If the sale was one with respect to which a loss, if sustained, would be recognized, the ceiling provided by section 422(c)(4) applies, since the amount realized on such sale is less than the fair market value of such share at the date of exercise. Accordingly, under section 422(c)(4), E must include only $50 (the excess of the amount realized on such sale, $150, over the amount paid for the stock, $100) as compensation in the taxable year in which the disqualifying disposition occurred. E realizes no capital gain or loss as a result of the sale, since his basis for the share of stock is $150 (the $100 which he paid for the share, plus the $50 increase in basis as a result of including such amount in his gross income). For its taxable year in which such disqualifying disposition occurs, Z is allowed a deduction of $50 as compensation attributable to E's exercise of his qualified stock option.

Example (3).—The facts are the same as in example (1), except that E sells the share for $50. If the loss is otherwise recognizable, section 422(c)(4) applies, and E does not include any amount in his gross income as compensation; but E has a capital loss of $50 (the difference between the amount realized on the sale, $50, and the amount paid for the stock, $100). Z is not allowed any deduction for compensation attributable to E's exercise of the qualified stock option.

Certain transfers by insolvent individuals

Paragraph (5) of section 422(c) provides an exception to the holding-period requirement of section 422(a)(1) with respect to certain transfers by insolvent individuals. If an insolvent individual holds a share of stock acquired pursuant to his exercise of a qualified stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding (including assignments for the benefit of creditors), neither such transfer, nor any other transfer of such share

for the benefit of the insolvent individual's creditors in such proceeding, shall constitute a "disposition of such share" for purposes of section 422(a)(1). An individual whose liabilities exceed his assets or who is unable to satisfy his liabilities as they become due is treated as insolvent for purposes of section 422(c)(5). Although the transfer of a share of stock to or by the trustee or other fiduciary is not considered a disposition for purposes of section 422(a)(1), a transfer by the trustee (other than a transfer back to the insolvent individual) constitutes a sale or exchange of the stock for purposes of recognition of any capital gain or loss. If the share is transferred by the trustee back to the insolvent individual, any subsequent disposition of the share by the insolvent individual which is not made in respect of the insolvency proceeding and for the benefit of his creditors in such proceeding is treated as a disposition for purposes of section 422(a)(1).

SECTION 423. EMPLOYEE STOCK PURCHASE PLANS

(*a*) *General rule.*—The new section 423(a) provides that the special tax treatment of section 421(a) applies to a transfer of a share of stock to an individual pursuant to his exercise of an option, if the option is granted after June 11, 1963 (other than a restricted stock option granted pursuant to a plan described in sec. 424(c)(4)(B)), under an employee stock purchase plan (as defined in sec. 423(b)), and if the holding-period and employment requirements set forth in paragraphs (1) and (2) of section 423(a) are met.

A number of corporations have established employee stock purchase plans under which the employees generally are permitted to purchase the stock of the employer at a discount. These plans have generally qualified under the existing section 421, and thereby, the employees have secured the special tax treatment of such section. Generally, under these plans an offering is made to the employees, and the right which is granted to each employee by means of this offering is treated as an option for purposes of section 421. The purchase of the stock under the offering is treated as the exercise of such option for purposes of section 421. Under the new section 423, these employee stock purchase plans are treated separately from the qualified stock options which are granted only to key or selected employees. Options granted under employee stock purchase plans will continue to receive substantially the same treatment as under the existing section 421.

Holding-period requirement

Paragraph (1) of the new section 423(a) is identical with the holding-period requirement provision of the existing section 421(a) and requires that the stock involved be held by the individual until 2 years from the date of the granting of the option and for 6 months after the transfer of the share to him.

Employment requirement

Section 421 in existing law expressly requires only that the individual is an employee of the granting corporation, its parent or subsidiary corporation, or a corporation or its parent or subsidiary corporation issuing or assuming a stock option in a transaction to which the existing section 425(g) applies, at the time the option is granted and at the time the option is exercised, or within the 3-month period preceding the date of exercise. Paragraph (2) of the new section 423(a)

requires that such individual be an employee of such a corporation from the date the option is granted through the day that is 3 months before the day on which the option is exercised. Thus, if an individual is granted an option under an employee stock purchase plan on September 10, 1964, and he exercises such option on May 3, 1966, the employment requirement is satisfied if at all times during the period beginning on September 10, 1964, and ending on February 3, 1966, he was an employee of the grantor corporation, its parent or subsidiary corporation, or a corporation or its parent or subsidiary corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(*b*) *Employee stock purchase plan.*—There is no specific definition of an employee stock purchase plan in present law. Under section 423 (b), the term "employee stock purchase plan" is defined for purposes of the revised part II as a plan that meets the requirements set forth in paragraphs (1) through (9). Section 423(b) also provides that any additional terms contained in an offering made under a plan will be treated as a part of the terms of the plan for purposes of satisfying the requirements of paragraphs (3) through (9) with respect to options exercised under such offering.

Options restricted to employees

Under paragraph (1) of section 423(b), the plan must restrict the grant of options to purchase stock in the employer corporation or its parent or subsidiary corporation to employees of such corporations.

Stockholder approval

Under paragraph (2) of section 423(b), the plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted.

Restriction on ownership

Under paragraph (3) of section 423(b), the plan must not permit the grant of an option to any employee who owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation. In determining the 5-percent limitation, the stock attribution rules of section 425(d) apply, and stock which the employee may purchase under any outstanding option is treated as stock owned by the employee.

Employees covered by plan

Under paragraph (4) of section 423(b), the plan must provide that options are to be granted to all employees of any corporation which grants options to any of its employees by reason of their employment by such corporation, except that one or more of the following categories of the employees may be excluded: employees who have been employed less than 2 years; employees whose customary employment is 20 hours or less per week; employees whose customary employment is for not more than 5 months in any calendar year; and officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

Equal rights and privileges

Under paragraph (5) of section 423(b), the plan must provide the same rights and privileges for all employees who are granted options.

Thus the provisions applying to one option under the plan (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under the plan in the same manner. For example, if an employee is permitted to make installment payments on the price of stock acquired pursuant to the exercise of an option granted under an employee stock purchase plan, all employees exercising options must be permitted to make installment payments in a like manner. However, this requirement does not prevent the maximum amount of stock that each employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock that each employee may purchase pursuant to an option granted under the plan is one share for each $100 of annual salary, such a provision does not prevent the plan from meeting the requirements of paragraph (5) even though it results in affording a high-salaried employee the right to purchase a greater amount of stock than a low-salaried employee. However, the fact that the amount of stock which can be purchased may be established on the basis of a uniform relationship to compensation may not be used to exclude lower salaried employees. For example, this provision does not permit the amount of stock that an employee may purchase pursuant to an option under a plan to be determined on the basis of one share for each $1,000 of annual salary in excess of $10,000. Paragraph (5) also provides that the plan may establish a maximum limit on the amount of stock that an employee can purchase. Thus a maximum limit may be imposed even though the amount of stock that can be purchased is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees.

Option price

Under paragraph (6) of section 423(b), the plan must provide that the option price is to be not less than the lesser of an amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or an amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised. The option price may be stated either as a percentage or as a dollar amount. This requirement is met by an option which provides that the option price is the lesser of a percentage (not less than 85 percent) of the fair market value of the stock at the time the option is granted or a percentage (not less than 85 percent) of the fair market value of the stock at the time the option is exercised. If the price is stated as a dollar amount, the requirement of paragraph (6) can only be met by an option in which the price fixed is at least 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at the time the option is granted, the option cannot meet the requirement of paragraph (6) even though there is a decline in the value of the stock with the result that the fixed price is 85 percent of the fair market value of the stock at the time the option is exercised. In such case, the option does not meet the requirement of paragraph (6) because this result is not certain to

occur under the terms of the option. If a plan contains a provision which is in accordance with the requirement of paragraph (6), and if an option is granted under such plan without in fact meeting the option price requirement of such paragraph, then such option does not qualify under section 423 because it has not been granted in accordance with an employee stock purchase plan as defined in section 423(b).

Period for exercising options

Under paragraph (7) of section 423 (b), the plan must limit the period during which the option may be exercised to 5 years from the date of grant if the price to be paid for the stock is to be determined solely as a percentage (not less than 85 percent) of its fair market value at the time the option is exercised. In the case of all other options to which section 423 applies, the plan must limit the period during which the option may be exercised to 27 months from the date of grant. For example, if the option provides simply that the option price is to be 85 percent of the fair market value of the stock at the time the option is exercised (irrespective of whether there is an increase or decrease in such fair market value), such option may be exercised within a 5-year period. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at the time of exercise, but not greater than 85 percent of the fair market value at the time of grant, such option may only be exercised within 27 months of the date of grant.

Restriction on amount of optioned stock

Under paragraph (8) of section 423(b), the plan must provide that no employee may be granted an option under the plan which permits his rights to purchase the stock of his employer corporation and its parent and subsidiary corporations under all employee stock purchase plans of such corporations to accrue at a rate in excess of $25,000 of fair market value (determined at the time the option is granted) of the stock of such corporations for each calendar year during which any such option granted to such individual is outstanding at any time. In applying the limitation under section 423(b)(8)—

(1) the right to purchase stock under an option accrues when the option (or any portion thereof) first becomes exercisable during the calendar year;

(2) the right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(3) a right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option.

This limitation applies only to options granted under employee stock purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in sec. 422(b)), restricted stock options (as defined in sec. 424(b)), or any other stock options (except those to which sec. 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

Under section 423(b)(8), an individual may be permitted to purchase up to $25,000 of stock in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, under section 423(b)(8), an individual may be permitted to purchase more than $25,000 of stock in a calendar year, if the total amount of stock which he may purchase does not exceed $25,000 for each calendar year during which any option granted to such individual under such a plan is outstanding. However, since the option may not permit the individual to purchase stock in excess of the rate of $25,000 for each calendar year the option is outstanding, the option may not permit him to purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may be permitted to purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding.

To illustrate the operation of section 423(b)(8), assume that P corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at $85 per share. On such date, the fair market value of P stock is $100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), E may not be permitted to purchase under such option more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to $25,000 in fair market value of P stock determined at the time of grant. During the calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between $50,000 in fair market value of P stock (determined at the time of grant) and the fair market value of P stock (determined at the time of grant) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between $75,000 in fair market value of such stock (determined at the time of grant) and the total amount of the fair market value of such stock (determined at the time of grant) purchased under such option during the calendar years 1964 and 1965.

In this example, E may be permitted to purchase under such option $25,000 of stock for the year 1964 and $25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or its parent or subsidiary corporations to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only $15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by its parent or subsidiary corporation, permitting him to purchase an additional $10,000 of stock for each year it is outstanding. If the option granted June 1, 1964, is terminated in 1965, E may be granted in 1966 or later another option (or options) to purchase stock under the plan so long as his rights to purchase stock under such option (or options) cannot accrue at a rate in excess of $25,000 of stock for each calendar year during which such an option is outstanding.

Under section 423(b)(8), the amount of stock which may be purchased under an option depends on the period during which the option

is outstanding. Thus, the amount of stock which may be purchased under an option may not be increased by reason of the failure to grant an option in an earlier year or by reason of the failure to exercise an earlier option. For example, if the option granted to E is terminated in 1965 without having been exercised at all, his failure to exercise the option does not increase the amount of stock which he may be permitted to purchase under a new option granted to him in 1966; under such option, he may be permitted to purchase only $25,000 of stock for 1966. If the option granted to E on June 1, 1964, expires on May 31, 1966, without having been exercised at all, E may be granted in 1966 a new option permitting him to purchase $25,000 of stock for such year, since E did not purchase any stock under any other option for such year. On the other hand, if in 1966 E exercised the option granted to him in 1964 and purchased 600 shares of the stock, 500 shares, the amount of stock which could have been purchased in 1965, is treated as purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of $15,000 at the time the new option is granted.

Restriction on transferability

Under paragraph (9) of section 423(b), the plan must not allow the transfer of an option other than by will or the laws of descent and distribution and must prohibit the exercise of such option by anyone other than the employee during his lifetime. This requirement is identical with subparagraph (B) of the existing section 421(d)(1).

(*c*) *Special rule where option price is between 85 percent and 100 percent of value of stock.*—Section 423(c) corresponds to the rule of the existing section 421(b) for stock acquired at an option price less than 95 percent of the value of the stock at the time the option was granted, but the new rule applies when the option price is less than 100 percent of the fair market value of the stock at the time the option is granted. Upon either the disposition of such stock or the death of the employee while owning such stock, there is included in gross income, as compensation for the taxable year in which the disposition or death occurs, an amount equal to the excess of the fair market value of the stock at the time of such disposition or death over the amount paid under the option, or the excess of the fair market value of the stock at the time the option was granted over the option price, whichever is the lesser. If the option price is not fixed or determinable at the time of grant, the option price is determined as if the option was exercised at such time. Section 423(c) also provides that the basis of the stock is to be increased by the amount so includible in gross income.

SECTION 424. RESTRICTED STOCK OPTIONS

(*a*) *In general.*—Section 424(a) retains the same treatment accorded restricted stock options under the existing provisions of section 421, if such options are granted before June 12, 1963, or if such options are granted after June 11, 1963, in accordance with section 424(c)(4). In continuing existing law, section 424(a) provides that the new section 421(a) applies to the transfer of a share of stock to an individual pursuant to his exercise of a restricted stock option if the holding

period and employment requirements set forth in paragraphs (1) and (2) of section 424(a) are met.

Holding-period requirement

Paragraph (1) of section 424(a) is identical with the holding-period requirement of the existing section 421(a) and requires that the stock be held by the individual until 2 years from the date of the granting of the option and for 6 months after the transfer of the share to him.

Employment requirement

Paragraph (2) of section 424(a) is identical with the employment requirement of the existing section 421(a) and requires that the individual be an employee of the granting corporation, its parent or subsidiary corporation, or a corporation or its parent or subsidiary corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, at the time the option is exercised, or within the 3-month period preceding the date of exercise.

(*b*) *Restricted stock option.*—Section 424(b) continues the definition of the term "restricted stock option" presently contained in section 421(d)(1) for options granted before June 12, 1963, or after June 11, 1963, in accordance with section 424(c)(4). Such an option must be granted to an individual, for a reason connected with his employment by the employer corporation or its parent or subsidiary corporation, to purchase stock in any such corporation and, in addition, must meet the following requirements:

(1) The option price, at the time of grant, must be at least 85 percent of the fair market value at such time of the stock subject to the option. For the purpose of determining whether such requirement is met in the case of a variable price option, the option price is computed as if the option is exercised at the time of the grant.

(2) The option can only be exercised by the employee during his lifetime and may not be transferable other than by will or the laws of descent and distribution.

(3) The employee, at the time of grant, must not own stock possessing more than 10 percent of the combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. However, such limitation does not apply if, at the time of grant, the option price is at least 110 percent of the fair market value of the stock subject to the option, and the option is not exercisable after the expiration of 5 years from the date of grant.

(4) The option must not be exercisable after 10 years from the date of grant.

(*c*) *Special rules.*—Section 424(c) provides three special rules relating to restricted stock options, all of which are identical to existing provisions of section 421, and a fourth special rule relating to certain options granted after June 11, 1963.

Options under which option price is between 85 percent and 95 percent of value of stock

Paragraph (1) of section 424(c) continues the rule of the existing section 421(b) in the case of stock acquired pursuant to the exercise of a restricted stock option under which the option price is between 85 and 95 percent of the value of the stock when the option is granted.

In case such an option has a fixed price, there is included in income as compensation upon a disposition of such stock, or upon the death of the optionee while owning such stock, the amount by which the option price is exceeded by the lesser of the fair market value of the stock at the time of such disposition or death, or the fair market value of the stock at the time of grant. Similarly, in case such an option has a variable price, there is included in income as compensation upon a disposition of such stock, or upon the death of the optionee while owning such stock, the amount by which the excess of the fair market value of the stock at the time of grant exceeds the option price (computed as if the option was exercised at such time), or the amount by which the fair market value of the stock at the time of such disposition or death exceeds the price paid under the option, whichever is the lesser. Paragraph (1) of section 424(c) also provides that the basis of the stock is to be increased by an amount equal to the amount so includible in gross income.

Stockholder approval

Paragraph (2) of section 424(c) continues the rule of the existing section 421(d)(5) that the date of the grant of a restricted stock option is determined without regard to stockholder approval.

Variable price option

Paragraph (3) of section 424(c) continues the definition of "variable price option" which is contained in the existing section 421(d)(7). The term "variable price option" means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; however, in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

Certain options granted after June 11, 1963

Paragraph (4) of section 424(c) provides the additional requirements that must be met by options granted after June 11, 1963, in order for such options to be treated as restricted stock options. In general, an option granted after June 11, 1963, that otherwise meets the requirements of section 424(b), is treated as a restricted stock option for all purposes of the revised part II of subchapter D if it was granted pursuant to—

(1) a binding written contract entered into before June 12, 1963, or

(2) a written plan adopted and approved before June 12, 1963, which (as of June 12, 1963, and as of the date of the granting of the option) either met the requirements of paragraphs (4) and (5) of section 423(b) or was being administered in a way that did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

In determining whether an option is granted pursuant to a plan described in item (2), the terms of any written offering that was made on or before June 12, 1963, will be treated as a part of the plan.

SECTION 425. DEFINITIONS AND SPECIAL RULES

(*a*) *Corporate reorganizations, liquidations, etc.*—Section 425(a) continues the existing provisions of section 421(g) under which the assumption or substitution of an option in connection with certain corporate transactions is not treated as the modification of an option. Such an assumption or substitution can occur by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if the aggregate spread between the option price and the value of all stock subject to the option immediately after the assumption or substitution is not greater than such spread under the option immediately before the assumption or substitution. The assumption or substitution also must not result in the employee obtaining additional benefits under the new option which he did not have under the old option. For the purpose of section 425(a), the parent-subsidiary relationship is determined at the time of the merger or other transaction that results in an assumption or substitution.

(*b*) *Acquisition of new stock.*—Section 425(b) is identical with the existing section 421(c) and provides that if stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036 of the code (or so much of section 1031 as relates to section 1036) applies, and if such distribution was made with respect to stock transferred pursuant to the exercise of an option, such stock shall be considered as transferred to him under the option. A similar rule applies to a series of such distributions.

(*c*) *Disposition.*—Section 425(c) continues the definition of the term "disposition" contained in paragraph (4) of the existing section 421(d). In general, a "disposition" includes a sale, exchange, gift, or transfer of legal title, but does not include a transfer from a decedent to an estate, a transfer by bequest or inheritance, an exchange to which section 354, 355, 356, or 1036 of the code (or so much of sec. 1031 as relates to sec. 1036) applies, or a mere pledge or hypothecation. No disposition occurs when an employee acquires stock in joint tenancy, or when he transfers stock into joint tenancy. However, a termination of such joint tenancy is a disposition except to the extent such employee acquires ownership of such stock.

(*d*) *Attribution of stock ownership.*—Section 425(d) continues the rules of subparagraph (C) of the existing section 421(d)(1) for purposes of applying the ownership limitations of sections 422(b)(7), 423(b)(3), and 424(b)(3). In general, the individual with respect to whom such limitation is being determined is considered to own the stock owned by his brothers and sisters, spouse, ancestors, and lineal descendants. Also, stock owned by or for a corporation, partnership, estate, or trust is considered as owned proportionately by its shareholders, partners, or beneficiaries.

(*e*) *Parent corporation.*—Section 425(e) is identical with the existing section 421(d)(2) and defines the term "parent corporation" to mean any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(*f*) *Subsidiary corporation.*—Section 425(f) is identical with the existing section 421(d)(3) and defines the term "subsidiary corporation" to mean any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in the chain.

(*g*) *Special rule for applying subsections* (*e*) *and* (*f*).—Section 425(g) provides that whenever the definition of "parent corporation" or "subsidiary corporation" is to be applied for purposes of section 422(a)(2), 423(a)(2), or 424(a)(2), the term "employer corporation" is to be replaced in such definitions by the term "grantor corporation" or the term "corporation issuing or assuming a stock option in a transaction to which section 425(a) applies," as the case may be.

(*h*) *Modification, extension, or renewal of option.*—Section 425(h) provides essentially the same rules as those contained in the existing section 421(e) for the modification, extension, or renewal of options. Paragraph (1) of section 425(h) continues the general rule of the existing section 421(e) that the modification, extension, or renewal of an option is considered as the granting of a new option.

Subparagraph (A) of section 425(h)(2) continues the rules of the existing section 421(e)(1)(B) for section 423 and 424 options and provides that, in the case of a modification, extension, or renewal, the fair market value of the stock at the time of grant is considered to be the highest of the fair market values on the date of the original granting of the option or the date the modification, extension, or renewal was made, or at the time any intervening modification, extension, or renewal was made. Subparagraph (B) of section 425(h)(2) continues the special rule of the existing section 421(e)(1) that provides an exception to the rule of section 425(h)(2)(A) if the average fair market value of the stock for the 12 months prior to the modification, extension, or renewal is less than 80 percent of the fair market value at the date of the original granting or any intervening modification, extension, or renewal, whichever is higher. This exception only applies to modifications, extensions, or renewals of restricted stock options made before June 12, 1963 (or made pursuant to a binding written contract entered into before June 12, 1963). Any modification, extension, or renewal of a restricted stock option is, under section 425(h)(1), considered as the granting of a new option, and therefore, if such modification, extension, or renewal occurs after June 11, 1963, and not pursuant to any binding written contract, the option, if it is to receive the special tax treatment of the new section 421(a), must qualify under section 422 or 423.

Paragraph (3) of section 425(h) defines the term "modification" in the same manner as the existing section 421(e). A modification is any change in the terms of an option which gives an employee additional benefits. However, the issuance or assumption of an option under section 425(a) is not considered a modification and a change which makes an option nontransferable is not considered a modification, if at the same time the time during which the option may be exercised is restricted to 10 years from the date of the grant of such option.

(*i*) *Cross references.*—Section 425(i) contains a cross reference to the new section 6039 (added by sec. 214(b) of the bill and discussed below).

SECTION 214. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS (Continued)

(*b*) *Administrative provisions.*—Subsection (b) of section 214 of the bill amends the code to provide certain new administrative provisions relating to employee stock options.

Reporting requirement for certain options

Paragraph (1) of section 214(b) of the bill redesignates the existing section 6039 of the code as section 6040 and inserts after section 6038 a new section 6039. The new section 6039 imposes a reporting requirement on corporations with respect to certain options described in part II of subchapter D of chapter 1 of the code (relating to certain stock options).

SECTION 6039. INFORMATION REQUIRED IN CONNECTION WITH CERTAIN OPTIONS

(*a*) *Requirement of reporting.*—Section 6039(a) provides that every corporation must make a return for each calendar year in which such corporation—

> (1) transfers a share of stock to any person pursuant to such person's exercise of a qualified or restricted stock option, or
>
> (2) records (or has by its agent recorded) a transfer of the legal title of a share of stock—
>
> > (A) acquired by the transferor pursuant to his exercise of an option referred to in section 423(c) (relating to special rule where option price is between 85 and 100 percent of value of stock), or
> >
> > (B) acquired by the transferor pursuant to his exercise of a restricted stock option referred to in section 424(c)(1) (relating to options under which option price is between 85 and 95 percent of value of stock).

The time for filing the return required by section 6039(a), the manner in which the return is to be filed, and the information to be included in the return will be prescribed in regulations issued by the Secretary of the Treasury or his delegate. A return is only required under paragraph (2) of section 6039(a) with respect to the first recorded transfer of the legal title of a share described in that paragraph. For example, if the first transfer of legal title is a transfer to the transferor and his wife as joint tenants, or a transfer into a street name, a return is required. However, no return will be required on subsequent transfers of such share. A return is required of the corporation whether or not the transfer of legal title constitutes a disposition within the meaning of section 425(c). In the case of a transfer of legal title that is reportable under paragraph (2) of section 6039(a), the only information that will be required is the reporting of the fact that such a transfer occurred and the name and address (including the account number) of the transferor. If a corporation uses a transfer agent, to record the transfer of legal title of its stock, it will be necessary for the

transfer agent to inform the corporation of any transfers described in paragraph (2) so that the corporation can file the returns required under such paragraph.

(*b*) *Statements to be furnished to persons with respect to whom information is furnished.*—Section 6039(b) requires a corporation making a return under section 6039(a) to furnish each person whose name is set forth on the return with such information as the Secretary of the Treasury or his delegate may by regulations prescribe. The information is to be provided in a written statement to be furnished to the taxpayer not later than January 31 of the year following the calendar year for which a return under section 6039(a) is made.

(*c*) *Identification of stock.*—Section 6039(c) requires any corporation transferring a share of stock pursuant to the exercise of a restricted stock option referred to in section 424(c)(1) (relating to options under which option price is between 85 and 95 percent of value of stock), or an option granted under an employee stock purchase plan and referred to in section 423(c) (relating to special rule where option price is between 85 and 100 percent of value of stock), to identify such stock in a manner sufficient to enable the corporation or its transfer agent to report the transfer of the legal title of the share as required by section 6039 (a) and (b).

(*d*) *Cross references.*—Section 6039(d) contains cross references to certain definitions contained in sections 422(b), 423(b), and 424(b).

SECTION 214. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS (Continued)

Penalties for failure to file information returns

Paragraph (2) of section 214(b) of the bill amends section 6652(a) of the code (relating to failure to file certain information returns) to provide a penalty for the failure to file the return required by the new section 6039(a). The penalty is $10 for each failure to file a statement of the transfer of stock (or of legal title) as required by section 6039(a), not to exceed $25,000 for all failures (described in sec. 6652(a)) in any one calendar year.

Penalties for failure to furnish statements to persons with respect to whom returns are filed

Paragraph (3) of section 214(b) of the bill amends section 6678 of the code (relating to penalties for failure to furnish statements to persons with respect to whom returns are filed) to provide a penalty in the case of each failure to furnish a statement under the new section 6039(b) to a person with respect to whom a return is made under the new section 6039(a) unless such failure is due to reasonable cause and not to willful neglect. The penalty is $10 for each such statement not furnished, not to exceed $25,000 for all failures (described in sec. 6678) in any one calendar year.

(*c*) *Technical amendments.*—Subsection (c) of section 214 of the bill amends section 402(a)(3) of the code (relating to taxability of beneficiary of employees' trust) to reflect the new location of the definitions of "parent corporation" and "subsidiary corporation" under the amendment made by section 214(a) of the bill.

Subsection (c) of section 214 of the bill also amends section 691(c)(2)(B) of the code (relating to allowance of deduction for estate tax

in case of items constituting income in respect of a decedent) to reflect the amendment made by section 214(a) of the bill.

(*d*) *Clerical amendments.*—Subsection (d) of section 214 of the bill makes conforming changes to the table of parts for subchapter D of chapter 1 of the code and the table of sections for subpart A of part III of subchapter A of chapter 61 of the code.

(*e*) *Effective date.*—Subsection (e) of section 214 of the bill provides that the amendments made by section 214 apply to taxable years ending after June 11, 1963; except that the amendments made by section 214(b) (relating to administrative provisions) apply only to stock transferred pursuant to options exercised on or after January 1, 1964.

SECTION 215. INTEREST ON CERTAIN DEFERRED PAYMENTS

(*a*) *In general.*—Subsection (a) of section 215 of the bill adds a new section 483 to part III of subchapter E of chapter 1 of the code (relating to accounting periods and methods of accounting). In general, in the case of a contract for the sale or exchange of property which provides for little or no interest on deferred payments under the contract, the new section treats a portion of such payments as interest.

SECTION 483. INTEREST ON CERTAIN DEFERRED PAYMENTS

(*a*) *Amount constituting interest.*—Section 483(a) provides the general rule that part of each payment (under a contract for the sale or exchange of property) to which section 483 applies is to be treated as interest for all purposes of the code. The tax treatment of both the purchaser and the seller may be affected by the rules of section 483. Thus, the basis of property in the hands of a purchaser does not include that part of his payments under the contract which is treated as interest under section 483 and he is entitled to interest deductions for such part in accordance with his method of accounting.

The amount to be treated as interest under section 483 is determined by multiplying each payment to which such section applies by a fraction, (1) the numerator of which is the "total unstated interest" under the contract and (2) the denominator of which is the total of all the payments to which section 483 applies which are due under such contract.

(*b*) *Total unstated interest.*—Section 483(b) defines "total unstated interest," with respect to a contract for the sale or exchange of property, as an amount equal to the excess of (1) the sum of the payments to which section 483 applies which are due under the contract, over (2) the sum of the present values of such payments and the present values of any interest payments due under the contract. The present value of a payment is determined by discounting such payment from the date the payment is due under the contract back to the date of the sale or exchange. Thus, the present value of a payment is the amount which, if left at interest from the date of the sale or exchange to the date the payment is due, would have increased to an amount equal to such payment. The Secretary of the Treasury or his delegate is to prescribe regulations which provide the manner

in which such present value is to be computed as well as the rate of interest to be used. Such regulations are to provide that payments are to be discounted on the basis of 6-month brackets; and that the present value of any interest payment which is due not more than 6 months after the date of the sale or exchange is to be equal to 100 percent of such payment. Thus, a payment is to be discounted from the nearest date which marks a 6-month interval from the date of the sale or exchange. This will make it unnecessary to compute interest on a daily basis.

The computation and allocation of total unstated interest with respect to a contract for the sale or exchange of property is illustrated by the following example:

Example.—S sells Blackacre to P under a contract which provides that P is to make payments in three equal installments of $2,000 each, such installments being due 1, 2, and 3 years, respectively, from the date of the sale. No interest is provided for in the contract. Assume that the Secretary of the Treasury or his delegate has prescribed by regulations that 5 percent per annum compounded semiannually is the rate of interest to be used. Section 483 applies to all three payments the sum of which is $6,000. The present value of the installment due 1 year after the sale is $1,903.63 ($2,000 discounted for 1 year at 5 percent per annum compounded semiannually). The present values of the other two installments are $1,811.90 ($2,000 similarly discounted for 2 years) and $1,724.59 ($2,000 similarly discounted for 3 years). The sum of the present values of the three installments (the payments to which sec. 483 applies) is $5,440.12 and therefore the total unstated interest under the contract is $559.88 ($6,000 minus $5,440.12). The part of each installment treated as interest is $186.63, which is arrived at by multiplying the amount of such installment ($2,000) by a fraction, the numerator of which is $559.88 (total unstated interest) and the denominator of which is $6,000 (total of payments to which sec. 483 applies).

(*c*) *Payments to which section applies.*—Section 483(c) defines the payments to which section 483 applies.

In general

Paragraph (1) of section 483(c) provides that, except as provided in section 483(f), section 483 applies to a payment under a contract for the sale or exchange of property if all the following conditions are met:

Condition (1). Such payment constitutes part or all of the sales price.

Condition (2). Such payment is due more than 6 months after the date of the sale or exchange.

Condition (3). The contract is one that provides that some or all of the payments are due more than 1 year after the date of the sale or exchange.

Condition (4). There is "total unstated interest" under the contract (computed by using a rate provided in regulations prescribed for this purpose by the Secretary of the Treasury or his delegate).

Thus, if a contract provides for one or more payments due more than 1 year after the date of the sale or exchange and the other conditions are met, section 483 applies even to those payments which are due

less than 1 year, but more than 6 months, from the date of the sale or exchange. Section 483 does not apply to a disposal of coal or iron ore described in section 631(c) of the code if the payments are made within 1 year from the date such coal or iron ore is mined since under section 631(c) the date of disposal of such coal or iron ore is deemed to be the date such coal or iron ore is mined.

The rate prescribed by the Secretary of the Treasury or his delegate for determining whether there is total unstated interest for purposes of condition (4) will be at least 1 percentage point lower than the rate he prescribes for purposes of section 483(b)(2). If the amount of interest specified in the contract is less than the amount which would result from using the rate prescribed by the Secretary or his delegate for determining whether there is total unstated interest for purposes of condition (4), the total unstated interest will be computed by using the higher rate prescribed for purposes of section 483(b)(2).

Treatment of evidence of indebtedness

Paragraph (2) of section 483(c) provides that the payments due under an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property, rather than the evidence of indebtedness itself, are considered as the payments due under the contract for such sale or exchange. In such case, the total unstated interest under the contract is computed under section 483(b) as if the payments under the evidence of indebtedness are due under the contract itself and as if the terms of the evidence of indebtedness are terms of the contract.

(*d*) *Payments that are indefinite as to time, liability, or amount.*—Section 483(d) provides that if the liability for, or amount or due date of, any portion of a payment under a contract for the sale or exchange of property cannot be determined at the time of such sale or exchange, section 483 is applied separately to such portion as if it (and any interest attributable to it) were the only payments due under the contract. For purposes of applying section 483 to such portion, the amount of such portion will be the amount paid and its due date will be the date it is paid. Under this provision, section 483 applies separately to the portion of a payment which is indefinite even though the remainder of the payment is fixed. Section 483 will be applied separately to the aggregate of the payments and portions of payments due under a contract other than those which are treated separately under section 483(d).

(*e*) *Change in terms of contract.*—Section 483(e) provides that if the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, section 483 will be applied to the contract as changed, with adjustment for interest (including unstated interest) payments made prior to the change. The recomputation and allocation of the total unstated interest under the contract as changed is to be made under regulations prescribed by the Secretary of the Treasury or his delegate.

(*f*) *Exceptions and limitations.*—Section 483(f) contains five exceptions to, or limitations on, the applicability of section 483.

Sales price of $3,000 or less

Paragraph (1) of section 483(f) provides that section 483 does not apply to any payment on account of a sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price (exclusive of interest specified in the contract) cannot exceed $3,000. A contract calling for any payments which are indefinite as to liability or amount does not qualify under this exception if the total of the payments (exclusive of interest specified in the contract) due under the contract could exceed $3,000, even if in fact they do not.

Carrying charges

Paragraph (2) of section 483(f) provides that, in the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property is determined without regard to section 483, if any such amounts are treated under section 163(b) as if they included interest.

Treatment of seller

Paragraph (3) of section 483(f) excepts, in the case of the seller, amounts received on account of the sale or exchange of property from the tax treatment provided under section 483, if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231 of the code. The determination of whether this exception applies is made without regard to whether, in fact, the sale or exchange results in a gain or whether the gain (if any) would be recognized, or whether section 1245 or section 1250 of the code applies to some or all of the gain (if any).

Sales or exchanges of patents

Paragraph (4) of section 483(f) exempts from section 483 payments made pursuant to a transfer of the rights to a patent or an interest therein described in section 1235(a) of the code.

Annuities

Paragraph (5) of section 483(f) exempts from the tax treatment of section 483 any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies. Thus, in the case of both the purchaser and the seller, any such amount is not considered a payment to which section 483 applies.

SECTION 215. INTEREST ON CERTAIN DEFERRED PAYMENTS (Continued)

(*b*) *Clerical amendment.*—Subsection (b) of section 215 of the bill makes a clerical amendment to part III of subchapter E of chapter 1 of the code.

(*c*) *Certain carrying charges.*—Under the existing section 163(b) of the code, if personal property is purchased under a contract providing for installment payments of part or all of the purchase price and if the contract provides for carrying charges, but the portion thereof which constitutes interest cannot be ascertained, then the payments made under the contract are treated, for purposes of the interest deduction,

as if they included interest equal to 6 percent of the average unpaid balance. Subsection (c) of section 215 of the bill amends section 163(b) to provide the same treatment when services are purchased under a contract providing for installment payments.

(*d*) *Effective dates.*—Subsection (d) of section 215 of the bill provides that the amendments made by subsections (a) and (b) of such section apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. The amendment made by subsection (c) of section 215 applies to payments made during taxable years beginning after December 31, 1963.

SECTION 216. PERSONAL HOLDING COMPANIES

Section 216 of the bill deals with the treatment of personal holding companies and shareholders of such companies.

(*a*) *Personal holding company tax rate.*—Subsection (a) of section 216 of the bill amends section 541 of the code to provide that the personal holding company tax is equal to 70 percent of the undistributed personal holding company income.

Under existing law, the tax is equal to 75 percent of the undistributed personal holding company income not in excess of $2,000, and 85 percent of any excess over $2,000.

(*b*) *Definition of personal holding company.*—Section 542(a) of the code presently provides that a corporation is a personal holding company for any taxable year if—

(1) at least 80 percent of its gross income for such year is personal holding company income as defined in section 543, and

(2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

Subsection (b) of section 216 of the bill amends the gross income test in paragraph (1) of section 542(a) to provide, in effect, that adjusted ordinary gross income (as defined in the new sec. 543(b)(2)) is the standard for determining whether a corporation is a personal holding company, and to reduce from 80 to 60 percent the percentage which must be personal holding company income in order that a corporation be classified as a personal holding company.

The adjusted ordinary gross income test is illustrated by the following example:

Example.—Corporation M derives $80 gross income from the sale of merchandise, $150 gross income from dividends, and $100 gross income from real estate rents, and its personal holding company income with respect to rents (i.e., adjusted income from rents as defined in sec. 543(b)(3)) equals $20. Under existing law, corporation M is not a personal holding company since less than 80 percent of its gross income is personal holding company income, computed as follows:

	Gross income	Personal holding company income
Rents	$100	$100
Dividends	150	150
Sales of merchandise	80	-------------
Total	$330	$250

NOTE.—$250 equals 75.8 percent of $330.

However, the corporation meets the new 60-percent test based on adjusted ordinary gross income under section 542(a)(1) computed as follows:

	Adjusted ordinary gross income	Personal holding company income
Adjusted income from rents	$20	$20
Dividends	150	150
Sales of merchandise	80	
Total	$250	$170

NOTE.—$170 equals 68 percent of $250.

(c) *Excluded corporations.*—Section 542(c) of the code presently excepts from the definition of a personal holding company 11 categories of corporations. Paragraph (2) of section 542(c) excepts from the definition of a personal holding company a bank as defined in section 581 of the code, which includes a domestic building and loan association (as defined in sec. 7701(a)(19) of the code).

Paragraph (1) of section 216(c) of the bill amends paragraph (2) of section 542(c) to provide that (in addition to a bank) a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association is also excepted from the definition of a personal holding company if it satisfies all of the tests prescribed in section 7701(a)(19), other than those prescribed in subparagraphs (D) and (E) thereof (relating to restrictions on investments in property other than residential real property or real property used primarily for church purposes).

Paragraphs (6), (7), (8), and (9) of section 542(c) describe various types of finance companies and lending and investment corporations, such as licensed personal finance companies operating under the small loan (Russell Sage) laws of the several States (par. (6)); lending companies (not of the Russell Sage type) engaged in the consumer finance business (par. (7)); Morris plan banks (par. (8)); and finance companies engaged in the business of factoring inventories, accounts receivable, and otherwise financing the short-term and intermediate-term needs of business (par. (9)).

Paragraph (2) of section 216(c) of the bill strikes out paragraphs (6), (7), (8), and (9) of section 542(c), renumbers paragraphs (10) and (11) thereof as paragraphs (7) and (8), respectively, and adds a new paragraph (6) thereto to provide a single definition of all those lending and finance companies which are excepted from the personal holding company tax. The tests which must be met are provided in subparagraphs (A), (B), (C), and (D).

Sixty-percent-of-ordinary-gross-income test

Subparagraph (A) of the new section 542(c)(6) provides that 60 percent or more of the corporation's ordinary gross income (as defined in sec. 543(b)(1)) must be derived directly from the active and regular conduct of a lending or finance business. The term "lending or finance business" is defined in the new section 542(d)(1).

In order to meet the 60-percent test the corporation must actively and regularly engage in lending and financing activities. The fact that a corporation meets the requirement of the new subparagraph (C)

of section 542(c)(6) with respect to the extent to which it incurs certain business deductions is not relevant for purposes of determining whether the 60-percent test of the new subparagraph (A) is met.

Twenty-percent-of-ordinary-gross-income test

Subparagraph (B) of section 542(c)(6) provides that personal holding company income, plus interest described in section 543 (b)(2)(C), must not exceed 20 percent of the ordinary gross income. For purposes of this test, income which is derived directly from the active and regular conduct of a lending or finance business (including certain income, described in sec. 542(d)(3), received from subsidiary corporations which are lending or finance companies) is not considered to be personal holding company income. The entire amount of the gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders is treated as personal holding company income. Thus, for example, for purposes of the 20-percent test, the adjustments prescribed by section 543(b) (3) and (4) (relating to adjusted income from rents and adjusted income from mineral, oil, and gas royalties) are disregarded, as are the various percentage tests prescribed by paragraphs (2) through (6) of section 543(a).

Business expense test

Subparagraph (C) of section 542(c)(6) provides that the sum of the business-expense deductions (as defined in the new sec. 542(d)(2)) which are directly allocable to the active and regular conduct of the lending or finance business must equal or exceed the sum of—

(i) 15 percent of the first $500,000 of ordinary gross income derived from such business, plus

(ii) 5 percent of the next $500,000 of ordinary gross income derived from such business.

Thus, for example, a corporation which derives $700,000 of ordinary gross income from the active and regular conduct of a lending business is required to have at least $85,000 of deductions directly allocable to such business in order to meet the business expense test of subparagraph (C) of section 542(c)(6); that is, $75,000 (15 percent of $500,000) plus $10,000 (5 percent of $200,000).

If a corporation has at least $100,000 of such business-expense deductions (under the definition contained in the new sec. 542(d)(2)) it meets the business-expense test regardless of how large its ordinary gross income from the lending or finance business may be.

The requirement that the deductions be directly allocable to the active and regular conduct of the lending or finance business is illustrated by the following example: Assume that corporation N (which satisfies the requirements of subpars. (A) and (B) of sec. 542(c)(6)) has ordinary gross income (as defined in sec. 543(b)(1)) of $100,000 from its financing and lending activities and $20,000 from management or consulting fees. Its business deductions (as defined in sec. 542(d)(2)) amount to $31,000, consisting of $10,000, representing the salary of employee X (not a shareholder) whose sole duties are to perform the management and consulting services; $12,000, representing the salary of the general manager (not a shareholder) who spends two-thirds of his time managing the financing and lending activities and one-third of his time overseeing the work of X; and $9,000, representing the overhead of the corporation. It is deter-

mined that $5,000 of the overhead is directly allocable to the lending and finance activities. Since the sum of the deductions which are directly allocable to the lending and finance activities, $13,000 ($8,000, i.e., two-thirds of $12,000, plus $5,000), is less than 15 percent of the ordinary gross income derived from the lending or finance business, that is, 15 percent of $100,000, corporation N does not meet the business-expense test of subparagraph (C) of section 542(c)(6).

The business-expense test is separate and apart from the requirement of section 542(c)(6)(A) that the taxpayer must be engaged in the active and regular conduct of a lending or finance business.

Limitation on loans to shareholders

Subparagraph (D) of section 542(c)(6) retains the provisions of existing law limiting the total amount of the loans outstanding at any time during the taxable year to a 10-percent-or-more shareholder of the corporation to $5,000 in principal amount. For this purpose, stock which is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in sec. 544(a)(2)) is included.

Paragraph (3) of section 216(c) of the bill adds a new subsection (d) to section 542 to provide special rules for applying section 542(c)(6).

Definition of lending or finance business

Paragraph (1)(A) of section 542(d) defines a "lending or finance business" as a business of—

(i) making loans, or

(ii) purchasing or discounting accounts receivable, notes, or installment obligations.

The loans (and purchased or discounted paper) may be secured or unsecured, and (except as provided in sec. 542(c)(6)(D)) may be made to, or acquired from, any person.

Paragraph (1)(B) of section 542(d) excepts two types of investment activities from the term "lending or finance business."

Clause (i) of section 542(d)(1)(B) excepts from such term the business of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, if the loans or the specified forms of commercial paper have a remaining maturity in excess of 60 months. The remaining maturity is measured as of the time the taxpayer makes the loan or purchases or discounts the paper. In addition, the remaining maturity includes any period for which there may be a renewal or extension under the terms of an option exercisable by the borrower. Thus, if a corporation's business activities include making 3-year loans, renewable for an equivalent period at the borrower's option, the making of such loans does not constitute a lending or finance business for purposes of this definition since the remaining maturity at the time of such loans is 72 months. In a case where a separate agreement is made to extend an existing loan, or to make a loan at some time in the future, such agreement may be taken into account in measuring the remaining maturity of loans existing at the time of such agreement or loans made subsequent thereto.

Where, before a loan matures, the lender agrees to extend the term of the loan (or other debt obligation), the remaining maturity of the loan is redetermined as of the time of the granting of such extension.

For example, on January 1, 1965, corporation Q, a calendar-year taxpayer, lends $90,000 to individual R. The note signed by R

provides that the loan shall be paid in monthly installments of $1,000, plus interest, commencing February 1, 1965, for 4 years with the balance of $42,000 becoming due on February 1, 1969. On January 1, 1967, corporation Q and individual R agree that the $1,000 monthly payments of principal shall continue until the debt is liquidated. Under the terms of this extension, the debt will be completely liquidated on July 1, 1972. At the time of the original loan, it is treated as having a remaining maturity not in excess of 60 months, since the note provides that the loan is to be completely paid off in 4 years and 1 month. However, the loan exceeds the 60-month maximum on January 1, 1967, since, pursuant to the terms of the extension entered into on that date, the remaining maturity is 66 months (from January 1, 1967, to July 1, 1972). Accordingly, for corporation Q's taxable years 1967 through 1972, the loan to R is not considered part of a "lending or finance business."

Clause (ii) of section 542(d)(1)(B) excepts from the definition of a lending or finance business the business of making of loans evidenced by, or the purchasing of, certificates of indebtedness issued in a series, under a trust indenture, and in registered form or with interest coupons attached.

The fact that a corporation makes some loans which are described in either clause (i) or (ii) of section 542(d)(1)(B) does not prevent the corporation from satisfying the 60-percent requirement of section 542(c)(6)(A). However, the interest income derived from such loans is treated as income which is not derived directly from the active and regular conduct of a lending or finance business.

Definition of business deductions

Paragraph (2) of section 542(d) defines the business deductions which may be taken into account in applying the business-expense test of section 542(c)(6)(C).

Subparagraph (A) of section 542(d)(2) includes those deductions which are allowable only by reason of section 162 or section 404 of the code, but excludes those deductions allowable by such sections in respect of compensation for personal services rendered by shareholders (including members of the sharholder's family as described in sec. 544(a)(2)). The effect of this subparagraph is to exclude, for purposes of the business-expense test, deductions which are allowable under section 162 (or sec. 404) and under other provisions, such as interest which is specifically allowable as a deduction under section 163.

Subparagraph (B) of section 542(d)(2) includes those deductions allowable under section 167 of the code (relating to depreciation) and those deductions allowable under section 164 of the code for real property taxes, but in each case only to the extent that the property with respect to which such deduction is allowable is used directly in the active and regular conduct of the lending or finance business. Thus, depreciation of the office furniture and equipment, to the extent allocable to such lending or finance business, is included for purposes of the business-expense test of section 542(c)(6)(C). Similarly, real property taxes paid with respect to the portion of a building used as office space by such lending or finance business are included. However, deductions allowable under section 167 or 164 with respect to

investment property owned by the corporation are not included for this purpose.

Income received by a consumer finance company from certain domestic subsidiary corporations

Paragraph (3) of section 542(d) provides that in the case of a lending company which is authorized to engage in and is actively and regularly engaged in the small loan business (consumer finance business) under one or more State statutes providing for the direct regulation of such business, for purposes of the 20-percent income test of section 542 (c)(6)(B), there shall not be treated as personal holding company income the lawful income received from certain domestic subsidiary corporations. Such subsidiaries must themselves be excepted from the definition of a personal holding company under section 542(c)(6), and, in addition, stock possessing at least 80 percent of the voting power of all classes of stock of such subsidiary and at least 80 percent of each class of the nonvoting stock must be owned directly by the taxpayer small loan company.

(*d*) *Personal holding company income.*—Subsection (d) of section 216 of the bill amends section 543(a) of the code (relating to personal holding company income). It also amends section 543(b) to provide definitions of the new terms "ordinary gross income," "adjusted ordinary gross income," "adjusted income from rents," and "adjusted income from mineral, oil, and gas royalties."

The amended section 543(a) provides that for purposes of subtitle A, the term "personal holding company income" means the portion of the adjusted ordinary gross income (as defined in sec. 543(b)(2)) which consists of the items described in paragraphs (1) through (8) of such section.

Dividends, etc.

Paragraph (1) of section 543(a) as amended (relating to dividends, etc.) contains no substantive change from paragraph (1) of the existing section 543(a).

Rents

Section 543(a)(7) of existing law provides that rents are personal holding company income unless such rents constitute 50 percent or more of gross income.

Paragraph (2) of section 543(a) as amended (relating to rents), which corresponds to the existing section 543(a)(7), provides that only so much of the gross income from rents as is equal to the adjusted income from rents (as defined in sec. 543(b)(3)) is treated as personal holding company income. In addition, the 50-percent requirement is amended (1) to provide that such requirement is met only if the adjusted income from rents constitutes 50 percent or more of the corporation's adjusted ordinary gross income (as defined in sec. 543(b)(2)), and (2) to add a test which provides that such adjusted income from rents is not excluded from personal holding company income unless the personal holding company income for the taxable year, computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating all mineral, oil, gas, and copyright royalties as personal holding company income, is not more than 10 percent of the ordinary gross income as defined in section 543(b)(1).

The application of the 50-percent requirement and the 10-percent test is illustrated by the following examples:

Example (1).—Corporation A owns securities earning annually $50 in dividends, and a building from which it receives annual gross income from rents of $50. Depreciation, interest, and real property taxes allocable to the rents equal $25. Under existing law, since corporation A's gross rents ($50) equal 50 percent of its gross income ($100), such rents are excluded from personal holding company income and the personal holding company income ($50 in dividends) equals only 50 percent of gross income ($100). Thus corporation A is not a personal holding company. However, under the 50-percent requirement as provided in the new paragraph (2)(A) of section 543(a), all of corporation A's adjusted ordinary gross income is personal holding company income, computed as follows:

	Adjusted ordinary gross income	Adjusted income from rents
Gross income from rents	$50	$50
Dividends	50	
Gross income	100	
Less: Adjustments under sec. 543(b) (2) and (3), i.e., depreciation, interest, and real property taxes	25	25
Total	$75	$25

Since the adjusted income from rents ($25) does not constitute 50 percent or more of adjusted ordinary gross income (50 percent of $75), the $25 adjusted income from rents constitutes personal holding company income. Since the $50 in dividends is also personal holding company income, 100 percent of the corporation's adjusted ordinary gross income ($75) is personal holding company income.

Example (2).—Corporation F receives $40 in dividends and $150 of gross income from rents. Corporation F also realizes $10 in capital gain on the sale of securities. Corporation F's deductions for depreciation, interest, and real property taxes allocable to the rents equal $100. Under existing law the rents are not personal holding company income and corporation F is not a personal holding company, since its gross income from rents ($150) constitutes 50 percent or more of its gross income ($200). Under the 50-percent requirement of the new provisions, the adjusted income from rents, $50 ($150 less $100), is 55.5 percent of adjusted ordinary gross income of $90 ($200 less the sum of $100 of adjustments and $10 of capital gains). Accordingly the adjusted income from rents meets the new 50-percent requirement. However other personal holding company income (the dividend income of $40) is more than 10 percent of ordinary gross income $190 ($200 less $10). Therefore, even though the rental income meets the 50-percent requirement of section 543(a)(2)(A), the adjusted income from rents nevertheless constitutes personal holding company income. Thus, all of corporation F's adjusted ordinary gross income is personal holding company income.

Example (3).—Corporation M receives $250 in gross income from rents, $20 of dividends, and $130 from its sole shareholder as com-

pensation for the use of a building owned by the corporation and leased to the shareholder. Depreciation, interest, and property taxes totaling $100 are allocable to the $250 of rents. Under the amendment, the adjusted income from rents, $150 ($250 less $100), equals 50 percent of adjusted ordinary gross income, $300 ($400 less $100), and thus the 50-percent requirement is met. In addition, corporation M meets the 10-percent test of section 543(a)(2)(B), since personal holding company income for the taxable year (excluding compensation for the use of corporate property by corporation M's shareholder which is not considered personal holding company income for purposes of the 10-percent test), $20 of dividends, is not more than 10 percent of ordinary gross income ($400). Since the adjusted income from rents meets both the 50-percent requirement and the 10-percent test, the adjusted income from rents does not constitute personal holding company income.

Mineral, oil, and gas royalties

Section 543(a)(8) of existing law provides that mineral, oil, and gas royalties are personal holding company income unless—

(A) such royalties constitute 50 percent or more of the gross income, and

(B) deductions allowable under section 162 of the code (relating to trade or business expenses), other than compensation for personal services rendered by the shareholders, constitute 15 percent or more of the gross income.

Paragraph (3) of section 543(a) as amended, which corresponds to the existing section 543(a)(8), makes the following changes in the applicable tests for determining whether such royalty income is personal holding company income: (A) The 50-percent requirement is met only if the adjusted income from such royalties (as defined in sec. 543(b)(4)) constitutes 50 percent or more of the corporation's adjusted ordinary gross income; (B) a new test is added providing that such royalties are nevertheless treated as personal holding company income if other personal holding company income constitutes more than 10 percent of ordinary gross income; and (C) the 15-percent expense test is made more specific.

Under subparagraph (A) of section 543(a)(3), only the adjusted income from mineral, oil, and gas royalties (i.e., the gross income from such royalties reduced by the amounts provided in sec. 543(b)(4)) is included in the numerator for purposes of the 50-percent requirement; the denominator is the adjusted ordinary gross income (as defined in sec. 543(b)(2)) of the corporation. Thus, for example, if the gross income from such royalties equals $200, and the adjustments for depletion, etc., provided in section 543(b)(4) with respect to such royalties equal $60, then for purposes of determining whether 50 percent or more of the corporation's adjusted ordinary gross income is derived from such royalties, $140 ($200 less $60) is the numerator in the computation. Assuming that the corporation's other gross income consists of $35 in dividends and $115 in gross income from the sale of merchandise, the denominator in the computation, adjusted ordinary gross income, would be $290 ($200 less $60, plus $35 plus $115). Since $140 is less than 50 percent of $290, the adjusted income from royalties constitutes personal holding company income.

Subparagraph (B) of section 543(a)(3) provides that even if the 50-percent requirement is met, the adjusted income from mineral, oil, and gas royalties will constitute personal holding company income if the corporation's other personal holding company income is more than 10 percent of ordinary gross income (as defined in sec. 543(b)(1)). For purposes of this 10-percent test, copyright royalties and the adjusted income from rents are treated as personal holding company income.

Copyright royalties

Section 543(a)(9) of existing law provides that copyright royalties are personal holding company income unless—

(A) such royalties (exclusive of royalties derived from copyrights on works created by any shareholder) constitute 50 percent or more of gross income,

(B) personal holding company income (exclusive of copyright royalties other than those derived from copyrights on works created by a more-than-10-percent shareholder, and exclusive of dividends from any 50-percent-owned corporation which meets the requirements of sec. 543(a)(9)) does not exceed 10 percent of gross income, and

(C) the deductions allowable under section 162 of the code (other than deductions for compensation for personal services rendered by shareholders, and other than deductions for royalties paid to shareholders) constitute 50 percent or more of the gross income.

Copyright royalties are defined to include compensation for the use of statutory copyrights (except copyrights issued under sec. 2 or 6 of title 17 of the United States Code) and payments for performing rights in copyrighted works. However such term does not include compensation which is rent under existing section 543(a)(7) (determined without regard to the 50-percent requirement applicable to such rents).

Paragraph (4) of section 543(a) as amended adopts the provisions of the existing section 543(a)(9), with the following changes:

(A) Under subparagraph (A) of section 543(a)(4), the 50-percent requirement is applied by measuring copyright royalty income against ordinary gross income (as defined in sec. 543(b)(1)), rather than against gross income as under existing law.

(B) Under subparagraph (B) of section 543(a)(4), the 10-percent test is measured against ordinary gross income, rather than against gross income as under existing law. In addition, a new clause is added to provide that adjusted income from rents (as defined in sec. 543(b)(3)) and adjusted income from mineral, oil, and gas royalties (as defined in sec. 543(b)(4)) are treated as personal holding company income for purposes of the 10-percent test.

For example, assume that corporation F receives $3,000 gross income from rents, and that its adjusted income from rents is $2,500. Corporation F also derives $7,000 in copyright royalty income from copyrights on works not created by a shareholder. The copyright royalties ($7,000) constitute 50 percent or more of ordinary gross income ($10,000). Accordingly the requirement of subparagraph (A) of section 543(a)(4) is met. However

since the adjusted income from rents ($2,500) exceeds 10 percent of corporation F's ordinary gross income ($10,000), the copyright royalties are not excluded from personal holding company income.

(C) In lieu of the 50-percent business-expense test of subparagraph (C) of section 543(a)(9) of existing law, subparagraph (C) of the new section 543(a)(4) provides that the business expenses must equal or exceed 25 percent of the amount by which ordinary gross income exceeds the sum of the royalties paid or accrued with respect to the copyright royalty income and amounts allowable as deductions under section 167 of the code with respect to the copyright royalty income. For this purpose only the deductions allowable under section 162 of the code are included, but the following deductions are not included:

(1) deductions not allocable to copyright royalty income;

(2) deductions for compensation for personal services rendered by the shareholders;

(3) deductions for royalties paid or accrued (even though allowable as a deduction under sec. 162); and

(4) deductions specifically allowable under sections other than section 162 (even though also allowable under sec. 162).

Thus, for example, assume corporation E owns a copyright on a popular song from which it derives $100 in royalties, and also operates a bowling alley with gross income therefrom of $50. Royalties paid to the composer of the copyrighted song are $50, expenses of operating the bowling alley are $45, and State income tax paid or accrued equals $5. Under subparagraph (C) of section 543(a)(4) none of the listed expenses qualifies for inclusion in determining whether corporation E's deductions allowable under section 162 are sufficient to remove the copyright royalties from the definition of personal holding company income.

(D) The definition of copyright royalties in paragraph (4) of section 543(a) is broadened to include payments (other than produced film rents as defined in sec. 543(a)(5)(B)) received for the use of, or right to use, films.

For purposes of paragraph (4) of section 543(a), payments for the transfer of the right to use a film (including television tapes) are treated as copyright royalties even though the transferee does not in fact intend to exhibit, distribute, or otherwise use such films.

Produced film rents

Under existing law, compensation for the use of, or right to use, films is treated as rents (regardless of when such rights are acquired) for personal holding company tax purposes.

Subparagraph (A) of the new section 543(a)(5) provides that unless produced film rents (as defined in subpar. (B)) constitute 50 percent or more of ordinary gross income, such produced film rents are personal holding company income.

Subparagraph (B) of section 543(a)(5) defines "produced film rents" as payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of the film. Film rents other than those defined in subparagraph (B) are treated as copyright royalties under section 543(a)(4) for personal holding company tax purposes.

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Whether an interest in a film is acquired before substantial completion of production of such film will be determined on the basis of all of the facts and circumstances in each case. Thus, for example, if two corporations form a joint venture for the purpose of acquiring the motion picture rights to a book, and the joint venture proceeds to adapt such book to motion picture screenplay form, and to produce the film, then the interest in the film acquired by the joint venturers is acquired before substantial completion of production of the film. If, as a result of major revisions in the screenplay, unavailability of leading actors and actresses, or other unexpected events occurring at an early stage in the actual production of the film, additional funds are required to continue production, an interest in the film acquired by another corporation at such time is acquired before substantial completion of production of the film.

On the other hand, if an interest in a film is acquired by a corporation at a time when most of the major scenes have been filmed, the payments received by such corporation with respect to such interest are not "produced film rents."

The term "produced film rents" does not include amounts which are personal holding company income under section 543(a)(7) (relating to personal service contracts).

Use of corporation property by shareholder

Under section 543(a)(6) of existing law, compensation for the use of, or right to use, the corporation's property by a 25-percent (or more) shareholder is personal holding company income only if the corporation's other personal holding company income exceeds 10 percent of gross income. For purposes of this 10-percent test, copyright royalties are treated as personal holding company income, but rents are not.

Under section 543(a)(6) as amended, the 10-percent test is applied with respect to ordinary gross income (as defined in sec. 543(b)(1)). In addition to copyright royalties, for purposes of this test, the adjusted income from mineral, oil, and gas royalties is included as personal holding company income notwithstanding that such royalties are excluded from personal holding company income under section 543(a)(3).

Personal service contracts

Paragraph (7) of section 543(a) as amended (relating to personal service contracts) is identical to section 543(a)(5) of existing law.

Estates and trusts

Paragraph (8) of section 543(a) as amended (relating to estates and trusts) is the same as section 543(a)(4) of existing law, except that gains from the sale or other disposition of any interest in an estate or trust are excluded from personal holding company income.

Gains from stocks, securities, and commodities transactions

The provisions of paragraphs (2) and (3) of the existing section 543(a), which include in the definition of personal holding company income gains (subject to the limitations in existing sec. 543(b) restricting such gains to the excess thereof over losses) from the sale or exchange of certain stock and securities, and gains from commodities transactions, have been deleted, and thus such gains will no longer constitute personal holding company income.

SECTION 216. PERSONAL HOLDING COMPANIES (Continued)

(*d*) *Personal holding company income* (continued).

Section 543(b) of existing law provides that for personal holding company tax purposes gains from stock and security transactions are included in gross income and personal holding company income only to the extent of the excess of gains over losses from such transactions. A similar rule applies to commodity transactions. These provisions have been deleted.

Under the amendment made by subsection (d) of section 216 of the bill, section 543(b) contains definitions for personal holding company tax purposes.

Ordinary gross income

Paragraph (1) of section 543(b) defines the term "ordinary gross income" as gross income determined by excluding—

(A) all gains from the sale or other disposition of capital assets, and

(B) all other gains from the sale or other disposition of property described in section 1231(b) of the code (relating to property used in a trade or business).

The computation of the amount to be excluded in computing ordinary gross income is illustrated by the following example:

Assume that corporation R sells two pieces of machinery for $100 each. Machine A has an adjusted basis of $80 and machine B has an adjusted basis of $108. Assume, further, that for purposes of section 1245(a)(2) of the code the recomputed basis of machine A equals $95. Corporation R's gain or loss on the sales of the two machines is computed as follows:

	Machine A	Machine B
Amount realized from sale	$100	$100
Less: Adjusted basis	80	108
Gain (loss) realized	$20	$(8)
Recomputed basis (sec. 1245(a))	95	
Less: Adjusted basis	80	
Amount of gain which is not treated as capital gain or sec. 1231 gain (sec. 1245(a)(1))	$15	

The $8 loss on the sale of machine B is not an item of gross income and, therefore, does not enter into the computation of ordinary gross income. Of the $20 gain from the sale of machine A, $15 is treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) of the code, and this is not excluded by paragraph (1) of section 543(b). The remaining $5 gain is gain from the sale of property described in section 1231(b), and is excluded by such paragraph (1) for purposes of determining corporation R's ordinary gross income.

The term "ordinary gross income" is used for the following purposes:

(1) In section 543(b)(2), in the computation of "adjusted ordinary gross income";

(2) In section 542(c)(6), to determine whether a lending or finance company meets the requirement that 60 percent or more

of its ordinary gross income must be derived directly from the active and regular conduct of a lending or finance business (sec. 542(c)(6)(A)); to apply the requirement that the personal holding company income (plus certain interest) must not exceed 20 percent of ordinary gross income (sec. 542(c)(6)(B)); and to apply the requirement that the deductions which are directly allocable to the active and regular conduct of the lending or finance business must equal or exceed 15 percent of the first $500,000 of ordinary gross income derived from such business, and 5 percent of the next $500,000 of such ordinary gross income (sec. 542(c)(6)(C));

(3) In section 543(a)(2)(B), to determine whether adjusted income from rents may be excluded from personal holding company income, to the extent that such exclusion depends upon the corporation having other personal holding company income not in excess of 10 percent of ordinary gross income;

(4) In section 543(a)(3)(B), to determine whether adjusted income from mineral, oil, and gas royalties are excluded from personal holding company income, to the extent that such exclusion depends upon the corporation having other personal holding company income not in excess of 10 percent of ordinary gross income;

(5) In section 543(a)(4), to determine whether copyright royalties are excluded from personal holding company income, to the extent that such exclusion depends upon the corporation meeting the requirement that such copyright royalties (exclusive of royalties on works created by shareholders) constitute 50 percent or more of ordinary gross income (sec. 543(a)(4)(A)); to apply the requirement that the other personal holding company income (with certain exceptions) must not exceed 10 percent of ordinary gross income (sec. 543(a)(4)(B)); and to apply the requirement that the sum of the business deductions of the corporation (with certain exceptions) must equal or exceed 25 percent of the ordinary gross income (reduced by royalties paid or accrued and depreciation and amortization with respect to the copyright royalties (sec. 543(a)(4)(C));

(6) In section 543(a)(5)(A), to determine whether produced film rents are excluded from personal holding company income by reason of constituting 50 percent or more of ordinary gross income; and

(7) In section 543(a)(6) (relating to compensation for the use of property of the corporation by a 25-percent-or-more shareholder), to determine whether personal holding company income exceeds 10 percent of ordinary gross income.

Adjusted ordinary gross income

Paragraph (2) of section 543(b) defines the term "adjusted ordinary gross income" as the ordinary gross income adjusted as provided in subparagraphs (A), (B), and (C) of such paragraph.

Adjusted ordinary gross income replaces the concept of gross income of existing law as the denominator in the fraction used in computing certain percentages involved in determining a corporation's status as a personal holding company. For example, under the

amended section 542(a)(1), a corporation is not a personal holding company unless at least 60 percent of its adjusted ordinary gross income for the taxable year is personal holding company income. Also, in determining whether adjusted income from rents (under sec. 543(a)(2)(A)) and adjusted income from mineral, oil, and gas royalties (under sec. 543(a)(3)(A)) are included in the definition of personal holding company income, such adjusted income from rents and royalties must each be measured against adjusted ordinary gross income. In addition, adjusted income from mineral, oil, and gas royalties is not excluded from personal holding company income unless the corporation's deductions which are allowable under section 162 of the code (with certain exceptions) constitute 15 percent or more of the adjusted ordinary gross income (sec. 543(a)(3)(C)).

With respect to the 50-percent tests in section 543(a) (2)(A) and (3)(A), the use of the concept of adjusted ordinary gross income is also reflected in the numerator of the pertinent fractions, as required by section 543(b) (3) and (4). Thus, in the case of rents and mineral, oil, and gas royalties, the adjustments provided in section 543(b) affect both the denominator (adjusted ordinary gross income) and the numerator (adjusted income from rents or adjusted income from such royalties, as the case may be) in determining whether such adjusted income from rents or royalties constitutes 50 percent or more of the adjusted ordinary gross income.

Rents

Subparagraph (A) of section 543(b)(2) provides that from the gross income from rents (as defined in the second sentence of sec. 543(b)(3)) there is to be subtracted the amounts allowable as deductions for exhaustion, wear and tear, obsolescence, and amortization; deductions for property taxes; interest deductions; and rent deductions; to the extent that such deductions are allocable, under regulations prescribed by the Secretary of the Treasury or his delegate, to the gross income from rents. In no case may the amounts subtracted under subparagraph (A) exceed the gross income from rents.

Regardless of the particular method or methods of computing depreciation used by the corporation, the total amount allowable therefor, including, where applicable, the additional first-year depreciation allowance under section 179 of the code, is subtracted from the total gross income from rents to the extent allocable thereto. If the corporation owns a purchased leasehold interest in real property, the amortization of the cost of such interest is subtracted from the company's gross income from rents. In addition, the amount of rent allowable as a deduction by the corporation with respect to a lease is subtracted from the company's gross income from rent. Deductions allowable for real and personal property taxes are also subtracted from such gross income.

Assume, for example, that real estate company J owns property which has gross rental income of $9,000. Its dividend income may be as much as $1,000 and still permit it to meet the 10-percent test of section 543(a)(2)(B) since the ordinary gross income is $10,000 ($9,000 plus $1,000) and 10 percent of such amount is $1,000. Company J may have deductions of the type for which subparagraph (A) of section 543(b)(2) requires adjustment of $8,000 and its adjusted income

from rent will meet the 50-percent requirement of section 543(a)(2)(A) as illustrated in the following computations:

	Adjusted ordinary gross income	Ordinary gross income
Gross rents	$9,000	$9,000
Less adjustments provided under sec. 543(b)(2)(A)	8,000	
Adjusted income from rents	1,000	
Dividends	1.000	1,000
Total	$2,000	$10,000

NOTE.—$1,000 (adjusted income from rents) equals 50 percent of $2,000.

The provision that prohibits the amounts subtracted under subparagraph (A) of section 543(b)(2) from exceeding the gross income from rents applies to the company's entire gross income from rents, rather than to each separate item of rental income. Thus, for example, assume that real estate company K owns two buildings, each producing $100 in gross income from rents. The deductions allowable for depreciation, mortgage interest, and real property taxes with respect to building No. 1 equals $80, and with respect to building No. 2 equals $110. In computing company K's adjusted ordinary gross income, $10 is included with respect to the gross income from rents from the two buildings.

Mineral royalties, etc.

Subparagraph (B) of section 543(b)(2) provides that from the gross income from mineral, oil, and gas royalties (as described in sec. 543(a)(3)), and from the gross income from working interests in an oil or gas well, there is to be subtracted the amounts allowable as deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion; deductions for property and severance taxes; interest deductions; and rent deductions; to the extent that such deductions are allocable, under regulations prescribed by the Secretary of the Treasury or his delegate, to the gross income from such royalties and such working interests. In no case may the amounts subtracted under subparagraph (B) with respect to royalties exceed the gross income from such royalties. Nor may the amount subtracted with respect to working interests in oil or gas wells exceed the gross income therefrom.

Interest

Subparagraph (C) of section 543(b)(2) provides that in computing adjusted ordinary gross income, there is excluded—

(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

(ii) interest on a condemnation award, a judgment, and a tax refund.

Adjusted income from rents

Paragraph (3) of section 543(b) defines the term "adjusted income from rents" as the gross income from rents, reduced by the amount

subtracted under section 543(b)(2)(A) with respect to certain deductions allocable to such gross income from rents. As in the case of the adjustments to rents for purposes of computing adjusted ordinary gross income, adjusted income from rents is computed by grouping all items of gross income from rents and subtracting therefrom the entire amount of the deductions computed under section 543(b)(2)(A). In addition, the corporation's adjusted income from rents may not be less than zero.

The term "adjusted income from rents" is used in section 543(a)(2) to describe the amount which is included as personal holding company income from rents unless such amount constitutes 50 percent or more of adjusted ordinary gross income and meets the 10-percent and 15-percent tests. It is also the amount which is treated as personal holding company income for purposes of the 10-percent tests of section 543(a) (3)(B) (relating to mineral, oil, and gas royalties) and (4)(B)(iii) (relating to copyright royalties).

Paragraph (3) of section 543(b) retains the same definition of rents which appears in section 543(a)(7) of existing law, with two exceptions. Produced film rents (as defined in sec. 543(a)(5)(B)) and other payments received for the use of, or right to use, films (which are treated as copyright royalties under sec. 543(a)(4)) are not classified as rents for personal holding company tax purposes under the amended paragraph (3).

Adjusted income from mineral, oil, and gas royalties

Paragraph (4) of section 543(b) defines the term "adjusted income from mineral, oil, and gas royalties" as the gross income from such royalties, reduced by the amount subtracted under section 543(b)(2)(B) with respect to certain deductions allocable to the gross income from such royalties.

As in the case of the adjustments to gross income from such royalties, for purposes of computing adjusted ordinary gross income, adjusted income from such royalties is computed by grouping all items of gross royalty income and subtracting therefrom the entire amount of the deductions computed under section 543(b)(2)(B). Also, the corporation's adjusted income from such royalties may not be less than zero.

The term "adjusted income from mineral, oil, and gas royalties" is used in section 543(a)(3) to describe the amount which is included as personal holding company income from such royalties unless such amount constitutes 50 percent of adjusted ordinary gross income and meets the 10-percent and 15-percent tests. It is also the amount which is treated as personal holding company income for purposes of the 10-percent tests of section 543(a) (2)(B) (relating to rents), (4)(B)(iii) (relating to copyright royalties), and (6) (relating to use of corporation property by shareholder).

SECTION 216. PERSONAL HOLDING COMPANIES (Continued)

(*e*) *Foreign personal holding company income and stock ownership.*—The existing section 553 of the code defines the term "foreign personal holding company income" as the portion of the gross income, determined for purposes of section 552, which consists of personal holding company income as defined in section 543, except that all interest

(whether or not treated as rent) and all royalties (including mineral, oil, gas, and copyright royalties) are included in such definition. Section 554 of the code presently provides that for purposes of determining whether a foreign corporation meets the requirements of a foreign personal holding company with respect to stock ownership, the rules provided in section 544 are applied but with appropriate references to foreign personal holding companies rather than to personal holding companies.

Subsection (e) of section 216 of the bill rewrites sections 553 and 554 to eliminate the necessity of referring to sections 543 and 544 for the definition of foreign personal holding company income and for rules for determining stock ownership. Thus, under the amendment, section 553 contains all of the relevant provisions which appear in sections 543 (a) and (b) and 553 of existing law, and section 554 contains all of the relevant provisions which appear in sections 544 and 554 of existing law.

Accordingly the substantive rules provided in sections 543 and 544 of existing law (which are made applicable to foreign personal holding companies by secs. 553 and 554 of existing law) are retained in the code, with respect to foreign personal holding companies, without change.

(*f*) *Dividends-paid deduction.*—The existing section 316(a) of the code defines a dividend for income tax purposes. Paragraph (2) of the existing section 316(b) of the code contains an additional definition of a dividend with respect to personal holding companies. Such paragraph (2) provides that the term "dividend" also means any distribution of property (whether or not a dividend within the meaning of sec. 316(a)) made by a personal holding company to its shareholders, to the extent of the corporation's undistributed personal holding company income as determined under section 545 (but without regard to distributions which qualify as dividends under par. (2) of sec. 316(b)). This special definition of a dividend in section 316(b)(2) does not apply to distributions in partial or complete liquidation of a personal holding company. The extent to which liquidating distributions qualify as dividends for purposes of the dividends-paid deduction provided in section 561 is determined under section 562(b).

Dividend defined

Paragraph (1) of section 216(f) of the bill amends paragraph (2) of section 316(b) of the code by placing the provisions thereof in a new subparagraph (A) and by adding a new subparagraph (B). The new subparagraph (B) provides that the term "distribution of property," as used in subparagraph (A), includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but limited as provided in clauses (i), (ii), and (iii).

Clause (i) of section 316(b)(2)(B) restricts the distributions which qualify as a "distribution of property" to those made to distributees other than corporate shareholders. Thus a distribution in complete liquidation of a personal holding company made to a corporate shareholder cannot be treated by such corporate shareholder as a dividend (and therefore the corporate distributee cannot qualify, with respect to such distribution, for the dividends-received deduction allowed by either sec. 243 or sec. 245).

Clause (ii) of section 316(b)(2)(B) further restricts the amount of a distribution which qualifies as a "distribution of property" to that amount which the distributing corporation designates as a dividend distribution and with respect to which the corporation notifies the noncorporate shareholders of such designation, under regulations prescribed by the Secretary of the Treasury or his delegate.

Clause (iii) of section 316(b)(2)(B) provides that the amount treated as a "distribution of property" cannot exceed the sum of the noncorporate shareholders' allocable share of the undistributed personal holding company income for the taxable year, computed without regard to distributions which are within the definition of section 316(b)(2)(B) and without regard to distributions in liquidation under section 562(b).

The effect of the new subparagraph (B) of section 316(b)(2) is that a personal holding company may eliminate its undistributed personal holding company income in the year in which it liquidates by designating as dividends all or a part of its liquidating distributions to noncorporate shareholders (includible as such in their gross income). These amounts also qualify for the dividends-paid deduction under section 561.

The application of the new subparagraph (B) of section 316(b)(2) is illustrated by the following example:

Example.—In 1964, corporation L has gross income of $320,000, all from dividends on stocks of domestic corporations. Its undistributed personal holding company income for the calendar year 1964, computed without regard to distributions in liquidation under section 316(b)(2)(B) and section 562(b), is $303,000, computed as follows:

	Taxable income	Undistributed personal holding company income
Dividend income	$320,000	$320,000
Less: 85 percent dividend received deduction	272,000	
Taxable income	48,000	
Normal tax and surtax (50 percent less $7,000)	$17,000	(17,000)
Undistributed personal holding company income (without regard to sec. 316(b)(2)(B))		$303,000

On December 31, 1964, pursuant to a plan of liquidation, corporation L distributes all of its assets (consisting of stocks with a fair market value of $9 million and $603,000 in cash, including $300,000 accumulated from prior years' earnings) equally to its three shareholders, individuals A and B and corporation C. Thus, A and B each receive a liquidating distribution in the amount of $3,201,000 (one-third of $9,603,000). Corporation L designates $202,000 (two-thirds of $303,000) of the distributions in liquidation to A and B as a dividend and so notifies them (in accordance with regulations). A and B each have an adjusted basis for their stock in corporation L of $2,900,000.

Under the amendment, A and B each treat $101,000 as a dividend and report a gain on the liquidation of the corporation of $200,000, computed as follows:

Distribution	$3, 201, 000	
Less: Amount designated as dividend by corporation L	101, 000	
		$3, 100, 000
Less: Basis in stock of corporation L		2, 900, 000
Gain on liquidation		$200, 000

The entire amount received by corporation C in liquidation of corporation L, $3,201,000, is treated as full payment in exchange for its stock of corporation L.

Application of section 301

Paragraph (2) of section 216(f) of the bill amends section 331(b) of the code to provide that distributions referred to in the new subparagraph (B) of section 316(b)(2) are distributions of property to which section 301 applies. Thus, amounts which are distributed to noncorporate shareholders by a personal holding company, and which meet all of the other requirements of section 316(b)(2)(B), are not treated as in payment in exchange for stock of the distributing corporation under section 331(a).

Distributions in liquidation

The existing section 562(b) of the code provides that for purposes of computing the deduction for dividends paid under section 561, a corporation may treat as a dividend—

(1) amounts distributed in either partial or complete liquidation to the extent that such amounts are properly chargeable to earnings and profits accumulated after February 28, 1913, and

(2) in the case of a complete liquidation of such corporation occurring within 24 months after the adoption of a plan of liquidation, any distribution pursuant to such plan, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which the distribution is made.

Paragraph (3) of section 216(f) of the bill amends section 562(b) of the code to include the provisions thereof in a new paragraph (1), except that such provisions are inapplicable in the case of personal holding companies (described in sec. 542) and foreign personal holding companies (described in sec. 552). The amendment does not alter the applicability of any of the rules provided in section 562 with respect to any distribution made by a corporation other than a personal holding company or a foreign personal holding company. In addition, a new paragraph (2) is added to section 562(b) to provide that in the case of a complete liquidation of a personal holding company, occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such 24-month period is treated as a dividend for purposes of computing the dividends-paid deduction under section 561, but only to the extent that such amount is distributed to corporate distributees and represents such corporate shareholders' allocable share of the undistributed personal holding company income for the taxable year of such distribution. For this purpose, undistributed personal holding company income is computed without regard to distributions described in the new paragraph

(2) of section 562(b) and without regard to distributions which qualify as "distributions of property" within the meaning of subparagraph (B) of section 316(b)(2).

The new paragraph (2) of section 562(b) provides that a personal holding company may include in its deduction for dividends paid a part of a distribution in complete liquidation to corporate shareholders. However, the amount of such distribution is not treated as a dividend by such shareholders.

The operation of the rule of the new paragraph (2) of section 562(b) is illustrated by referring to the preceding example (illustrating the application of new subparagraph (B) of sec. 316(b)(2)). In that example, even though individuals A and B each treated $101,000 of the $3,201,000 received in complete distribution of corporation L as a dividend, corporation C treats the entire amount of the distribution as in full payment in exchange for the stock of corporation L. In computing its dividends-paid deduction under section 561 for 1964, $101,000 of the amount of the distribution to corporation C is included by corporation L as well as the $202,000 designated as dividend distributions to A and B. Thus, corporation L has no undistributed personal holding company income in 1964, computed as follows:

Dividend income		$320,000
Less:		
Normal tax and surtax	$17,000	
Distributions to A and B designated as a dividend (sec. 316(b)(2)(B))	202,000	
Distribution to corporation C in liquidation (sec. 562(b)(2))	101,000	
		320,000
Undistributed personal holding company income		0

Amount included in gross income of a U.S. shareholder of a foreign personal holding company

The existing section 551(b) of the code describes the amount which must be included as a dividend in the gross income of any U.S. shareholder of a foreign personal holding company who is a shareholder on the day in the taxable year of the company which was the last day on which a U.S. group (as defined in sec. 552(a)(2)) existed with respect to the company. The amount to be included is the amount such U.S. shareholder would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholder, the proportionate part of the company's undistributed foreign personal holding company income for the taxable year represented by the ratio of the portion of the taxable year up to and including such last day to the entire taxable year.

Paragraph (4) of section 216(f) of the bill amends section 551(b) of the code to provide that the amount which would have been received as a dividend is determined as if any distribution in liquidation actually made in such taxable year had not been made. Thus, the fact that there may have been a distribution in liquidation will not affect the application of section 551 in treating the amounts specified therein as a dividend distribution to the shareholders.

(g) *One-month liquidations.*—The existing section 333 of the code permits certain corporations to liquidate without recognition by their shareholders of gain, subject to certain limitations on such nonrecognition with respect to earnings and profits of the corporation

accumulated after February 28, 1913, cash, and stock and securities acquired by the corporation after December 31, 1953.

Subsection (g) of section 216 of the bill adds a new subsection (g) to section 333 of the code.

Liquidations before January 1, 1966

Paragraph (1) of the new section 333(g) provides that if a corporation which is referred to in the new section 333(g)(3) is liquidated before January 1, 1966, in a liquidation to which section 333(a) applies—

(A) the date "December 31, 1953," referred to in section 333 (e)(2) and (f)(1) is to be treated as if such date were "December 31, 1962," and

(B) in the case of stock in the liquidating corporation held by a qualified electing shareholder for more than 6 months, the term "a dividend" as used in section 333(e)(1) is to be treated as if such term were "class B capital gain."

The effect of subparagraph (A) of section 333(g)(1) is that in the case of any liquidation of a corporation referred to in the new section 333(g)(3) to which the provisions of section 333(a) apply, and which is completed in any calendar month before the month of January 1966, no gain will be recognized to a qualified electing shareholder with respect to the distribution by the liquidating corporation of stock or securities acquired by the corporation before January 1, 1963.

Under subparagraph (B) of section 333(g)(1), a qualified electing noncorporate shareholder who has held the stock of the liquidating corporation for more than 6 months will, in computing his recognized gain under section 333(e)(1) with respect to such stock, treat as a class B capital gain (notwithstanding that his holding period for such stock is more than 2 years) so much of his realized gain on such stock as is not in excess of such stock's ratable share of the corporation's earnings and profits accumulated after February 28, 1913.

Subparagraph (B) does not apply with respect to stock held by a qualified electing shareholder for 6 months or less.

Paragraph (1) of section 333(g) also provides that subparagraph(B) of such paragraph does not apply to earnings and profits to which the corporation succeeds after August 1, 1963, pursuant to any corporate reorganization or pursuant to any liquidation to which section 332 applies, except earnings and profits which on August 1, 1963, constituted earnings and profits of a corporation referred to in section 333(g)(3), and except earnings and profits which were earned after such date by a corporation referred to in section 333(g)(3). Thus, for example, if corporation K (a corporation referred to in sec. 333(g)(3)) succeeds to the earnings and profits of corporation L (a corporation not referred to in sec. 333(g)(3)) under section 381 of the code in a transaction occurring before August 2, 1963, then corporation K's earnings and profits (including the earnings and profits of corporation L to which it succeeded) are treated as class B capital gain for purposes of applying section 333(e)(1) to a noncorporate shareholder of corporation K. If on January 1, 1964, corporation M (a corporation referred to in sec. 333(g)(3)) succeeds to corporation K's earnings and profits under section 381, all such earnings and profits succeeded to by corporation M are treated as class B capital gain for purposes of applying section 333(e)(1) because the earnings and profits of corporation K on August 1, 1963, qualify in corporation

M's hands as earnings and profits which constituted earnings and profits of a corporation referred to in section 333(g)(3), and the earnings and profits of corporation K accumulated from August 2, 1963, to January 1, 1964, qualify as earnings and profits earned by a corporation referred to in section 333(g)(3). If, however, the transaction in which corporation K succeeded to the earnings and profits of corporation L occurred after August 1, 1963, such earnings and profits are not treated as class B capital gain to a noncorporate shareholder of either corporation K or corporation M, but instead are treated as a dividend under section 333(e)(1).

The application of the provisions of section 333(g)(1) is illustrated by the following example:

Corporation M, which is a corporation referred to in section 333(g)(3), adopts a plan of liquidation on January 2, 1964. Its assets on such date consist of the following items:

	Fair market value
Stock in corporation X (acquired 1956)	$3, 000, 000
Stock in corporation Y (acquired 1963)	550, 000
Real property	200, 000
Total assets	$3, 750, 000

On January 1, 1964, corporation M's earnings and profits accumulated after February 28, 1913, are $250,000. Pursuant to the plan of liquidation, corporation M distributes all of its assets before January 31, 1964, to individual D, its sole shareholder, who acquired the stock of corporation M in 1956 and whose adjusted basis in such stock is $2 million. D's total gain realized on the liquidation is $1,750,000 ($3,750,000 less $2 million). Assuming the election provided in section 333(d) is properly made, D recognizes and treats as class B capital gain $250,000 (corporation M's accumulated earnings and profits) under section 333 (e)(1) and (g)(1)(B), and recognizes as class A capital gain $300,000, computed as follows:

The fair market value of the stock in corporation Y, acquired after Dec. 31, 1962	$550, 000
Less: D's share of accumulated earnings and profits	250, 000
Class A capital gain (under sec. 333 (e)(2) and (g)(1)(A))	$300, 000

The remainder of D's realized gain, $1,200,000, is not recognized at the time of the liquidation of corporation M.

Liquidations after December 31, 1965

Paragraph (2) of the new section 333(g) provides rules which apply to certain section 333 liquidations occurring after December 31, 1965.

In general

Subparagraph (A) of section 333(g)(2) provides the general rule that in the case of a liquidation occurring after December 31, 1965, of a corporation which is referred to in section 333(g)(3) and which meets the requirements of subparagraph (B) of section 333(g)(2)—

(i) the date "December 31, 1953," referred to in section 333 (e)(2) and (f)(1) is treated as if such date were "December 31, 1962," and

(ii) in the case of stock in the liquidating corporation held by a noncorporate qualified electing shareholder for more than 6 months, so much of the gain recognized under section 333(e)(1) as is attributable to the corporation's earnings and profits accumulated after February 28, 1913, and before January 1, 1966, is treated as class B capital gain, and only the remainder of the gain so recognized is treated as a dividend.

Subparagraph (A) of section 333(g)(2) also provides that clause (ii) of such subparagraph does not apply to earnings and profits to which the corporation succeeds after August 1, 1963, pursuant to any corporate reorganization or pursuant to any liquidation to which section 332 applies, except earnings and profits which on August 1, 1963, constituted earnings and profits of a corporation referred to in section 333(g)(3), and except earnings and profits which were earned after such date and before January 1, 1966, by a corporation referred to in section 333(g)(3).

Clause (i) of section 333(g)(2)(A) has the same effect with respect to liquidations occurring after December 31, 1965, as does subparagraph (A) of section 333(g)(1) with respect to liquidations occurring before January 1, 1966.

The effect of clause (ii) of section 333(g)(2)(A) is that a noncorporate qualified electing shareholder who has held the stock of the liquidating corporation for more than 6 months, in computing his recognized gain under section 333(e)(1), divides his ratable share of the corporation's earnings and profits accumulated after February 28, 1913, into three parts, described as follows:

(1) A part which represents earnings and profits (to which the corporation succeeded after August 1, 1963) which on August 1, 1963, constituted earnings and profits of a corporation which is not referred to in section 333(g)(3), and which were not earned after such date by a corporation which is so referred to.

(2) A part which represents earnings and profits accumulated before January 1, 1966, other than the part described in item (1).

(3) A part which represents earnings and profits accumulated after December 31, 1965.

That part which is described in item (2) is treated as class B capital gain. That part which is described in item (1), and that part (described in item (3)) which is accumulated up to the date the corporation liquidates in a liquidation to which section 333 is applicable, is treated as a dividend.

Corporations to which applicable

Subparagraph (B) of section 333(g)(2) provides that subparagraph (A) applies only to a corporation which is referred to in section 333(g)(3) and which meets the requirements of clauses (i), (ii), and (iii).

Clause (i) of section 333(g)(2)(B) provides that the corporation must owe qualified indebtedness (as defined in sec. 545(c)(3)) on August 1, 1963.

Clause (ii) provides that before January 1, 1967, the corporation must notify the Secretary of the Treasury or his delegate that it may wish to have section 333(g)(2)(A) apply to it, and must submit such information as may be required by regulations prescribed by the Secretary or his delegate.

Clause (iii) provides that the corporation must liquidate before the close of the earlier of (1) the taxable year in which such corporation ceases to owe the qualified indebtedness referred to in clause (i), or (2) the taxable year referred to in section 333(g)(2)(C).

Adjusted post-1963 earnings and profits equal to or exceeding qualified indebtedness

Subparagraph (C) of section 333(g)(2) provides that in the case of any corporation the taxable year referred to in such subparagraph for purposes of section 333(g)(2)(B)(iii) is the first taxable year at the close of which its adjusted post-1963 earnings and profits equal or exceed the amount of the corporation's qualified indebtedness on August 1, 1963. For this purpose, the term "adjusted post-1963 earnings and profits" is defined as the sum of—

(i) the corporation's earnings and profits for taxable years beginning after December 31, 1963, without diminution by reason of any distributions made out of such earnings and profits, and

(ii) the deductions allowed for taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, or amortization.

The effect of subparagraph (C) of section 333(g)(2) is that the special rule of section 333(g)(2) (relating to liquidations after Dec. 31, 1965) may be elected only if the liquidation occurs prior to the close of the year in which the corporation ceases to owe qualified indebtedness or, if earlier, the year in which such qualified indebtedness could have been retired if the sum of the corporation's earnings and profits accumulated after December 31, 1963, its dividend distributions out of such accumulated earnings and profits, and its depreciation and amortization deductions for all taxable years beginning after December 31, 1963, had all been applied toward retiring such qualified indebtedness. For this purpose a corporation is considered to have no accumulated earnings and profits on January 1, 1964. Thus, an accumulated deficit which exists on January 1, 1964, for purposes of section 316(a) is disregarded.

Corporations referred to

Paragraph (3) of the new section 333(g) describes the corporations to which paragraphs (1) and (2) of section 333(g) may apply. Such a corporation is one which was not a personal holding company under section 542 for at least one of its two most recent taxable years ending before the date of enactment of section 333(g), but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

A corporation which was a personal holding company for both of its two most recent taxable years ending before the date of enactment of section 333(g) is not a corporation referred to in paragraph (3) of section 333(g). Nor is a corporation so referred to if it would not have been a personal holding company for either of such two most recent taxable years had the amendments contained in section 216 of the bill applied to such taxable years.

The application of the provisions of section 333(g)(3) is illustrated by the following example:

In 1961, 80 percent of the gross income of corporation W, a calendar-year taxpayer more than 50 percent of the stock of which is owned by four individuals, is personal holding company income. In 1962, additional operating income is added, with the result that only 70 percent of its gross income (and adjusted ordinary gross income) for that year is personal holding company income. Assume that section 333(g) is enacted on December 15, 1963. Corporation W's two most recent taxable years ending before the date of enactment are 1961 and 1962; corporation W was a personal holding company for 1961, but was not a personal holding company for 1962 since it did not meet the 80-percent income test of the existing section 542(a)(1) of the code for such year. However, corporation W would have been a personal holding company for 1962 if the provisions of sections 542(a)(1) and 543, as amended by section 216 of the bill, were applied to such year, since 60 percent or more of its adjusted ordinary gross income for such year is personal holding company income. Thus, corporation W is a corporation referred to in section 333(g)(3).

(*h*) *Exception for certain corporations.*—Subsection (h) of section 216 of the bill provides an exception for certain corporations from the applicability of the amendments made to the code by section 216 of the bill (other than subsecs. (f) and (g)).

Paragraph (1) of section 216(h) of the bill provides the general rule that in the case of a corporation which is referred to in section 333(g)(3), as added by section 216(g) of the bill, the amendments made by subsections (a), (b), (c), (d), (e), (i), and (k) of section 216 do not apply if there is a complete liquidation of such corporation and if the distribution of all of the corporation's property under such liquidation occurs before January 1, 1966. Thus, if the conditions provided in paragraph (1) of section 216(h) are met, a corporation will continue to have the provisions of existing law (with respect to the definition of a personal holding company) apply through December 31, 1965. However, the amendments made by subsections (f) and (g) of section 216 apply to such a corporation as of the effective date for such amendments.

The application of the provisions of paragraph (1) of section 216(h) of the bill may be illustrated by referring to the preceding example in the discussion of the new section 333(g)(3). In that example, assume further that, for 1964, 70 percent of corporation W's adjusted ordinary gross income (and gross income) is personal holding company income and that, as a result of additional dividend-paying securities being added in 1965, 80 percent of the adjusted ordinary gross income (and gross income) for the taxable year ending in 1965 is personal holding company income. On November 1, 1965, corporation W adopts a plan of complete liquidation, and in pursuance thereof distributes all of its property to its shareholders by November 10, 1965. Since corporation W is a corporation referred to in the new section 333(g)(3) and since it is liquidated and all of its property is distributed before January 1, 1966, the general rule of paragraph (1) of section 216(h) applies, and the amendments made by section 216 to the definition of a personal holding company are inapplicable to corporation W for 1964 and 1965. Thus, since corporation W does not meet the 80-percent test of the existing

section 542(a)(1) of the code for the year 1964, it is not a personal holding company for such year. Subject to the applicable period of limitations, a claim for refund may be filed for any personal holding company tax which was paid with respect to 1964 and which was computed on the basis of the applicability of the amendments made by section 216 of the bill. However, corporation W is a personal holding company for the short taxable year ending on November 10, 1965, since it meets the 80-percent income test of the existing section 542(a)(1) of the code. In addition, the amendments made by subsection 216(f) of the bill (relating to dividends-paid deduction) apply. Accordingly, distributions to noncorporate shareholders in liquidation of corporation W do not constitute dividends for purposes of computing the deduction for dividends paid for the short taxable year ending November 10, 1965, unless, and to the extent that, in accordance with the new subparagraph (b) of section 316(b)(2), corporation W designates the amount of such distributions in liquidation which are to be treated as a dividend distribution for purposes of the definition of a dividend provided in section 316(b)(2)(A). If corporation W has any corporate shareholders, the amounts received by them under the complete liquidation are treated as in full payment in exchange for stock. However, corporation W treats such amounts as dividends to the extent provided in the new section 562(b)(2) for purposes of computing its deduction for dividends paid under section 561. The shareholders of corporation W treat their liquidating distributions (except to the extent that sec. 316(b)(2)(B) applies) in accordance with the applicable provisions of the code relating to amounts received in corporate liquidations (including sec. 333(g)(1), as added by sec. 216(g) of the bill) subject, however, to the exception provided in paragraph (2) of section 216(h) of the bill with respect to liquidations to which section 332 applies.

Paragraph (2) of section 216(h) of the bill provides that paragraph (1) of section 216(h) does not apply to any liquidation to which section 332 of the code applies unless both of the conditions set forth in subparagraphs (A) and (B) of section 216(h)(2) of the bill are satisfied.

Subparagraphs (A) and (B) of section 216(h)(2) of the bill require that the 80-percent-or-more corporate shareholder (referred to in sec. 332(b)(1)) in such section 332 liquidation must be liquidated in a complete liquidation to which section 332 does not apply, and that the distribution of all the property pursuant to the liquidation of such corporate shareholder must occur before the 91st day after the last distribution pursuant to the liquidation of the subsidiary corporation, but not later than December 31, 1965.

(*i*) *Deduction for amortization of indebtedness.*—Subsection (i) of section 216 of the bill provides a new deduction from taxable income for purposes of determining undistributed personal holding company income (as defined in sec. 545(a) of the code), and makes technical and conforming amendments.

Paragraph (1) of section 216(i) of the bill amends section 545(a) of the code to provide that the term "undistributed personal holding company income" means the taxable income of a personal holding company adjusted in the manner provided in sections 545(b) (relating to adjustments to taxable income) and 545(c) (relating to special adjustment to taxable income for amortization of qualified indebtedness), minus the deduction for dividends paid (as defined in sec. 561).

Paragraph (2) of section 216(i) of the bill adds a new subsection (c) to section 545 of the code to provide a special adjustment to taxable income for purposes of section 545(a) (relating to the definition of undistributed personal holding company income).

SECTION 545(C). SPECIAL ADJUSTMENT TO TAXABLE INCOME

In general

Paragraph (1) of the new section 545(c) provides the general rule that, except as otherwise provided in such section, there shall be allowed as a deduction (in computing undistributed personal holding company income) amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness (as defined in sec. 545(c)(3)). An amount is considered to be irrevocably set aside within the meaning of paragraph (1) only if the corporation could not use such amount for any purpose except to retire the qualified indebtedness with respect to which it was set aside.

Corporations to which applicable

Paragraph (2) of the new section 545(c) describes the corporations which may qualify for the deduction provided in paragraph (1) of such section.

Subparagraph (A) of section 545(c)(2) provides that to qualify for such deduction a corporation must be one which, for at least one of its two most recent taxable years ending before the date of enactment of section 545(c), was not a personal holding company under section 542 but would have been a personal holding company under section 542 if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year. See the discussion of the new section 333(g)(3) and the example therewith (above).

Subparagraph (B) of section 545(c)(2) provides that, although a corporation does not itself meet the requirements of section 545(c)(2)(A), it qualifies for the deduction provided in section 545(c)(1) to the extent that it succeeds to the deduction referred to in such paragraph (1) by reason of section 381(c)(15) of the code (relating to the carryover of qualified indebtedness) as amended by section 216(i)(3) of the bill. The fact that under section 381(c)(15) an acquiring corporation is considered to be the distributor or transferor corporation with respect to qualified indebtedness of such distributor or transferor corporation, for purposes of the deduction provided in section 545(c)(1), does not affect such acquiring corporation's status as a corporation eligible for such deduction with respect to indebtedness other than that to which it succeeded under section 381(c)(15).

Qualified indebtedness

Paragraph (3) of the new section 545(c) defines the term "qualified indebtedness."

Subparagraph (A) of such paragraph prescribes the rule that, except as provided in subparagraphs (B) and (C), the term "qualified indebtedness" means—

(i) the outstanding indebtedness incurred by the taxpayer after December 31, 1933, and before August 1, 1963, and

(ii) the outstanding indebtedness incurred after July 31, 1963, for the purpose of making a payment or set-aside referred to in section 545(c)(1) in the same taxable year, subject to the condition, however, that if such payment or set-aside is made at any time on or after the first day of the first taxable year beginning after December 31, 1963, such indebtedness incurred after July 31, 1963 (hereinafter referred to as "substituted indebtedness"), is treated as qualified indebtedness only to the extent that the deduction otherwise allowed for such payment or set-aside is treated as nondeductible by reason of the corporation's election provided under section 545(c)(4).

The application of the provisions of subparagraph (A) is illustrated by the following examples:

Example (1).—Corporation D, a calendar-year taxpayer, has $6 million of indebtedness outstanding on July 31, 1963 (which was incurred after 1933), represented by demand notes, and on January 15, 1964, it borrows $8 million, $6 million of which amount is used, in the same taxable year, to liquidate the outstanding indebtedness. The retirement of such $6 million of indebtedness qualifies as a payment referred to in section 545(c)(1), and is allowable as a deduction for purposes of computing undistributed personal holding company income for 1964. However, if corporation D elects, under section 545(c)(4), not to deduct $5 million of the $6 million deduction which is otherwise allowable under section 545(c)(1), then $5 million of the $8 million of new indebtedness is treated as qualified indebtedness under section 545(c)(3)(A).

Example (2).—Corporation H, a calendar-year taxpayer, has $500,000 of outstanding indebtedness on July 31, 1963 (which was incurred after 1933). On October 1, 1963, it borrows $100,000 to make a payment on December 1, 1963, into a sinking fund with respect to the $500,000 outstanding indebtedness. The new indebtedness incurred is qualified indebtedness. However, if the sinking fund payment is not in fact made until 1964, the new indebtedness is not qualified indebtedness because the payment into the sinking fund was not made in the taxable year in which the new indebtedness was incurred.

Subparagraph (B) of section 545(c)(3) provides that qualified indebtedness (as defined in subparagraph (A)) does not include any amounts which were, at any time after July 31, 1963, and before the payment or set-aside described in section 545(c)(1), owed to a person who at such time owned more than 10 percent in value of the corporation's outstanding stock. For this purpose, the rules of section 318(a) (relating to constructive ownership of stock) apply.

Subparagraph (C) of section 545(c)(3) provides that qualified indebtedness with respect to a contract is reduced by amounts irrevocably set aside to pay or retire such indebtedness before the taxable year. In addition, no deduction is allowed under section 545(c)(1) for payments out of amounts so set aside. Thus, for example, if a corporation incurred indebtedness of $1 million on February 1, 1960, and, in accordance with its contract of indebtedness, irrevocably set aside $50,000 in a sinking fund on February 1 of 1961, 1962, 1963, 1964, and 1965, then its qualified indebtedness on August

1, 1963, under subparagraph (A)(i) of section 545(c)(3), as reduced by subparagraph (C) thereof, is $850,000 ($1 million less three set-asides of $50,000 each in 1961, 1962, and 1963). The corporation is allowed a deduction for $50,000 each in 1964 and 1965 (provided the deduction is not reduced by the application of any other provision of sec. 545(c)) and the qualified indebtedness on January 1, 1966, is $750,000 ($850,000 less two set-asides of $50,000 each in 1964 and 1965). No deduction is allowed to the corporation with respect to any payment from the sinking fund which is used to retire any part of the qualified indebtedness.

Election not to deduct

Paragraph (4) of section 545(c) provides that a corporation may elect, under regulations prescribed by the Secretary of the Treasury or his delegate, to treat as nondeductible an amount otherwise deductible under paragraph (1) thereof. Such election must be filed on or before the 15th day of the 3d month following the close of the taxable year with respect to which such election applies, and the corporation must designate therein the amounts which are to be treated as nondeductible, and must specify the substituted indebtedness (referred to in sec. 545(c)(3)(A)(ii)) incurred for the purpose of making the payment or set-aside referred to in section 545(c)(1). See examples (1) and (2) in the discussion of qualified indebtedness under section 545(c)(3)(A) (above).

Limitations

Paragraph (5) of section 545(c) provides certain limitations on the amount of the deduction otherwise allowed by section 545(c)(1). Under paragraph (5), such deduction is reduced by the sum of the amounts described in subparagraphs (A) and (B) thereof.

The amount by which the deduction is reduced under subparagraph (A) of section 545(c)(5) is the amount, if any, by which—

(i) the deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, or amortization, exceed

(ii) any reduction, by reason of the limitation provided in section 545(c)(5)(A), of the deductions otherwise allowed by section 545(c) for such preceding taxable years.

For purposes of clause (i), depreciation or amortization deductions which are disallowed in computing undistributed personal holding company income under section 545(b)(8) are not included.

The application of section 545(c)(5)(A) is illustrated by the following example:

Example.—Corporation R, a calendar-year taxpayer, has qualified indebtedness of $600,000 on August 1, 1963, with respect to which payments of $200,000 are made on January 1, 1964, 1966, and 1968. Corporation R is allowed a deduction for depreciation of $75,000 on its business assets for each of its taxable years 1964 through 1968. For the calendar year 1964, corporation R is allowed a deduction under section 545(c)(1), as limited by section 545(c)(5), of $125,000, computed as follows:

Amount paid in taxable year to retire debt	$200, 000
Less depreciation deduction, 1964	75, 000
Total	$125, 000

For the calendar year 1966, corporation R is allowed a deduction of $50,000, computed as follows:

Amount paid in taxable year to retire debt		$200, 000
Less:		
Depreciation deductions allowed for 1964, 1965, and 1966 (3 times $75,000)	$225, 000	
Reduction of deduction in 1964	75, 000	
		150, 000
Total		$50, 000

For the calendar year 1968, corporation R is allowed a deduction of $50,000, computed as follows:

Amount paid in taxable year to retire debt			$200, 000
Less:			
Depreciation deductions allowed for 1964, 1965, 1966, 1967, and 1968 (5 times $75,000)		$375, 000	
Reduction of deductions:			
1964	$75, 000		
1966	150, 000		
		225, 000	
			150, 000
Total			$50, 000

The amount by which the deduction otherwise allowed by section 545(c)(1) is reduced under subparagraph (B) of section 545(c)(5) is the amount, if any, by which—

(i) the deductions allowed under section 545(b)(5) (relating to long-term capital gains) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

(ii) any reduction, by reason of the limitation provided in section 545(c)(5)(B), of the deductions otherwise allowed by section 545(c) for such preceding taxable years.

Pro rata reduction in certain cases

Paragraph (6) of section 545(c) provides that the total amounts of the taxpayer's qualified indebtedness (as defined in sec. 545(c)(3)(A)) are reduced if property (of a character which is subject to the allowance for exhaustion, wear and tear, obsolescence, or amortization) is disposed of after July 1, 1963. Such reduction is made pro rata in the taxable year of such disposition and is equal to the amount, if any, by which—

(A) the adjusted basis of such property at the time of such disposition, exceeds

(B) the amount of qualified indebtedness which ceased to be qualified indebtedness by reason of the assumption of the indebtedness by the transferee.

Under this provision, if, for example, property is transferred to a subsidiary corporation, and the transferee assumes the mortgage on the property, the qualified indebtedness of the transferor is reduced by the excess, if any, of the basis of the property transferred over the

amount of the mortgage assumed. However if the subsidiary takes the property subject to the mortgage, and the transferor remains liable on the mortgage, then the transferor's qualified indebtedness is reduced by the full amount of the basis of the property transferred.

SECTION 216. PERSONAL HOLDING COMPANIES (Continued)

Paragraph (3) of section 216(i) of the bill amends paragraph (15) of section 381(c) of the code (relating to carryovers in certain corporate acquisitions) to provide that the acquiring corporation is considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 545 (b)(7) and (c) of the code (relating to deduction with respect to payment of certain indebtedness).

(*j*) *Increase in basis with respect to certain foreign personal holding company holdings.*—Subsection (j) of section 216 of the bill provides for an increase in the basis of certain foreign personal holding company holdings.

In general

Paragraph (1) of section 216(j) of the bill redesignates section 1022 of the code as section 1023 and adds to the code a new section 1022.

SECTION 1022. INCREASE IN BASIS WITH RESPECT TO CERTAIN FOREIGN PERSONAL HOLDING COMPANY HOLDINGS

(*a*) *General rule.*—Section 1014(b)(5) of the code provides that the basis of a share of stock or of a security in a foreign personal holding company, in the hands of a person acquiring it from a decedent by bequest, devise, or inheritance, or acquired by the decedent's estate from the decedent, is the lower of the fair market value of such share or security at the date of the decedent's death or the basis in the hands of the decedent. The new section 1022(a) provides that the basis determined under section 1014(b)(5) of a share of stock or a security, acquired from a decedent dying after August 15, 1963, of a corporation which was a foreign personal holding company for its most recent taxable year ending before the date of the enactment of the bill is to be increased by such share's or security's proportionate share of any Federal estate tax attributable to the net appreciation in value of all of such shares and securities.

(*b*) *Proportionate share.*—The new section 1022(b) provides that a share's or security's proportionate share of the tax referred to in section 1022(a) is an amount which bears the same ratio to the amount of tax determined under section 1022(c)(2) as the appreciation in value of the share or security bears to the aggregate appreciation in value of all such shares and securities having appreciation in value.

(*c*) *Special rules and definitions.*—The new section 1022(c) provides special rules and definitions to be used in determining the increase in basis provided in section 1022(a).

Federal estate tax

Paragraph (1) of section 1022(c) defines the term "Federal estate tax" to mean the tax imposed by section 2001 or 2101 of the code, reduced by any credit allowable with respect to a tax on prior transfers by section 2013 or 2102 of the code.

Federal estate tax attributable to net appreciation in value

Paragraph (2) of section 1022(c) provides that the Federal estate tax attributable to the net appreciation in value of all shares of stock and securities to which section 1022(a) applies is the amount which bears the same ratio to the Federal estate tax as the net appreciation in value of all of such shares and securities bears to the value of the gross estate as determined under chapter 11 of the code. If, for estate tax purposes, alternate valuation is elected under section 2032 of the code, the value of the gross estate is to be determined under the provisions of such section.

Net appreciation

Paragraph (3) of section 1022(c) provides that the net appreciation in value of all shares and securities to which section 1022(a) applies is the amount by which the fair market value of all shares and securities exceeds the adjusted basis of such property in the hands of the decedent.

Fair market value

Paragraph (4) of section 1022(c) defines "fair market value", for purposes of section 1022, to mean such value determined under chapter 11 of the code. If, for estate tax purposes, alternate valuation is elected under section 2032 of the code, fair market value is to be determined as of the appropriate date provided in such section.

(*d*) *Limitation.*—The new section 1022(d) provides that section 1022 is not to apply to any stock or securities of a foreign personal holding company referred to in section 342(a)(2) of the code (relating to foreign corporations which were foreign personal holding companies in 1937).

SECTION 216. PERSONAL HOLDING COMPANIES (Continued)

Amendment of section 1016(a)

Paragraph (2) of section 216(j) of the bill adds a new paragraph (21) to section 1016(a) of the code, providing, in effect, that an increase in basis under section 1022 of the code or section 216(j)(5) of the bill is to be taken into account in determining the adjusted basis of property to which such sections apply.

Clerical amendment

Paragraph (3) of section 216(j) of the bill makes a clerical amendment to the table of sections for part II of subchapter O of chapter 1 of the code.

One-month liquidations

Paragraph (4) of section 216(j) of the bill provides that certain foreign personal holding companies are to be treated as domestic corporations for purposes of section 333 of the code (relating to 1-month liquidations), and are to be treated as foreign corporations for purposes of section 367 of the code (relating to foreign corporations). In addition, the first sentence of such section 367 is to be treated as including a reference to such section 333. The provisions of paragraph (4) of section 216(j) of the bill apply to a corporation only if (A) it was a foreign personal holding company for its most recent taxable year ending before the date of enactment of the bill, (B) all of the stock of such corporation is owned on August 15, 1963,

and at the time of liquidation, by individuals and estates, and (C) the transfer of all the property under the liquidation occurs within one of the first 4 calendar months ending after such date of enactment.

The effect of these provisions is to allow a foreign personal holding company to which paragraph (4) of section 216(j) of the bill applies to liquidate under the provisions of section 333 of the code if, before such liquidation, it has been established to the satisfaction of the Secretary of the Treasury or his delegate that the liquidation is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Basis of certain property acquired from a decedent

Paragraph (5)(A) of section 216(j) of the bill provides that the basis of property described in paragraph (5)(B) of such section acquired from a decedent or passing from a decedent (within the meaning of sec. 1014(b) of the code) is (in lieu of being the basis provided by sec. 1014 of the code) the same as the basis of such property immediately before the death of the decedent (in most cases, the basis under sec. 334(c) of the code, properly adjusted) increased by the amount of any Federal estate tax attributable to the net appreciation in value of such property. Such increase is to be determined in accordance with the provision of section 1022 of the code as if such property were stock and securities referred to in such section.

Paragraph (5)(B) of section 216(j) of the bill provides that paragraph (5)(A) is to apply to—

(1) property which the decedent received as a qualified electing shareholder (within the meaning of sec. 333(c) of the code) in a corporate liquidation to which section 333 of the code applied by reason of section 216(j)(4) of the bill, and

(2) property the basis of which (determined without regard to the provisions of sec. 216(j)(5) of the bill) is a substituted basis (as defined in sec. 1016(b) of the code) (A) determined by reference to property received by a qualified electing shareholder in a corporate liquidation to which section 333 of the code applied by reason of section 216(j)(4) of the bill or (B) determined by reference to other property having a basis which is determined by reference to the basis of property received by a qualified electing shareholder in such a liquidation.

Paragraph (5)(C) of section 216(j) of the bill provides that, in the case of property acquired from the decedent by gift, the increase in basis for estate tax paid under such section is not to exceed the amount by which the increase determined in accordance with section 1022 of the code is greater than the increase in basis for gift tax paid which is allowable under section 1015(d) of the code.

Limitation

Paragraph (6) of section 216(j) of the bill provides that the provisions of paragraphs (4) and (5) of such section do not apply to any foreign corporation referred to in section 342(a)(2) of the code.

Meaning of terms

Paragraph (7) of section 216(j) of the bill provides that terms used in paragraphs (4) through (6) of such section are to have the same meaning as when used in chapter 1 of the code.

(*k*) *Technical amendments.*—Subsection (k) of section 216 of the bill makes certain technical changes to provisions of the code to conform those provisions to the changes made by section 216 of the bill.

Corporations filing consolidated returns for personal holding company tax purposes

Paragraph (1) of section 216(k) of the bill amends section 542(b) of the code (relating to corporations filing consolidated returns) to conform the references to "gross income" therein to the new concept of "adjusted ordinary gross income."

Special adjustment to personal holding company income, etc.

Paragraph (2) of section 216(k) of the bill repeals section 543(d) of the code (relating to special adjustment on disposition of antitrust stock received as a dividend).

Rules for determining stock ownership

Paragraph (3) of section 216(k) of the bill amends section 544 of the code to conform all of the references therein to paragraphs (5) and (9) of section 543(a) of the code to the appropriate paragraphs as contained in the amendments made by section 216 of the bill.

Real estate investment trusts

Paragraph (4) of section 216(k) of the bill amends section 856(a)(6) of the code (relating to definition of real estate investment trusts) to conform that section to the new concept of "adjusted ordinary gross income."

Unincorporated business enterprises electing to be taxed as domestic corporations

Paragraph (5) of section 216(k) of the bill amends section 1361(i) of the code (relating to personal holding company income of unincorporated business enterprises electing to be taxed as corporations) to conform such section to the changes made by section 216 of the bill, and to repeal paragraph (4) of such section 1361(i). The rule presently provided in paragraph (4) of section 1361(i) is consolidated in paragraph (1) of section 1361(i) as amended by this paragraph of the bill.

As amended by this paragraph of the bill, paragraph (1) of section 1361(i) provides that there is excluded from the gross income of an enterprise as to which an election has been made under section 1361(a) any item of gross income (computed without regard to the adjustments provided in sec. 543(b) (3) or (4) with respect to adjusted income from rents and mineral, oil, and gas royalties) if, but for paragraph (1) of section 1361(i), such item (adjusted, where applicable, as provided in sec. 543(b) (3) or (4)) would constitute personal holding company income (as defined in sec. 543(a)) of such enterprise. Thus, for example, if the adjusted income from rents would not meet both the 50-percent requirement and the 10-percent test provided in section 543(a)(2), such adjusted income from rents would be personal holding company income under section 543(a). Accordingly the

gross income from such rents is excluded from the gross income of the enterprise under paragraph (1) of section 1361(i).

Paragraphs (2) (relating to income and deductions of owners) and (3) (relating to distributions by the enterprise) of section 1361(i) are rewritten to conform to the changes made to paragraph (1) of section 1361(i).

Assessment and collection of personal holding company tax

Paragraph (6) of section 216(k) of the bill amends section 6501(f) of the code (relating to assessment and collection of personal holding company tax) to include a reference to items of adjusted ordinary gross income.

(*l*) *Effective dates.*—Under subsection (l) of section 216 of the bill, the amendments made by section 216 (other than by subsecs. (c)(1), (f), (g), and (j)) apply to taxable years beginning after December 31, 1963. The amendment made by subsection (c)(1) (relating to domestic building and loan associations) applies to taxable years beginning after October 16, 1962. The amendments made by subsections (f) (relating to dividends-paid deduction) and (g) (relating to 1-month liquidations) apply with respect to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963, notwithstanding that the taxable year of the distributee in which such a distribution must be taken into account or otherwise treated under any provision of law may be a taxable year which begins before December 31, 1963. The amendments made by paragraphs (1), (2), and (3) of subsection (j) apply in respect of decedents dying after August 15, 1963. Subsection (h) applies to taxable years beginning after December 31, 1963.

SECTION 217. TREATMENT OF PROPERTY IN CASE OF OIL AND GAS WELLS

(*a*) *In general.*—Subsection (a) of section 217 of the bill amends section 614 of the code (relating to special rules as to operating mineral interests) by striking out the existing subsection (b) and inserting in its place a new subsection (b). The existing section 614(b) provides special rules relating to the election to aggregate separate operating mineral interests and treat such aggregation as one property for purposes of computing the depletion allowance, and for all other purposes of subtitle A of the code, in the case of mines, wells, and other natural deposits. In the case of mines, the existing section 614(b) has no application with respect to any taxable year beginning after December 31, 1957. Under that section, if a taxpayer owns two or more separate operating mineral interests which constitute part or all of an operating unit, he may elect (for all purposes of subtitle A of the code) to form one aggregation of, and to treat as one property, any two or more of such interests; and to treat as a separate property each such interest which he does not elect to include within such aggregation.

The new section 614(b) provides rules for the treatment of operating mineral interests in the case of oil and gas wells for taxable years beginning after December 31, 1963, which rules are, generally, in conformity with the practices prevailing prior to the enactment of the code in 1954. The amendment of section 614(b) by this section of the bill makes no change in the present treatment of operating mineral

interests in the case of minerals other than oil and gas, or in the present treatment of nonoperating mineral interests in the case of any mineral including oil and gas. These types of mineral interests will continue to be treated under the existing provisions of section 614 (c) and (e). Likewise, there has been no change in the general rule, set forth in section 614(a), defining a property as a separate interest in each mineral deposit in each separate tract or parcel of land. No inference is to be drawn from the amendment made by section 217(a) of the bill as to the correctness of aggregations formed by taxpayers under the existing section 614(b) with respect to past years.

In general

Paragraph (1) of the new section 614(b) of the code provides, as a general rule, that in the absence of the election provided in paragraph (2) of such section all of the operating mineral interests of the taxpayer contained within a separate tract or parcel of land will be combined and treated as one property. Thus, if a taxpayer wishes to treat all the operating mineral interests in one tract or parcel of land as a single property, no election is required to achieve this result. The combining of operating mineral interests under paragraph (1) is limited to those interests which are contained within the same tract or parcel of land. Thus, an operating mineral interest in one tract or parcel of land may not be combined with an operating mineral interest in another tract or parcel of land. As under present law, an operating mineral interest cannot be combined with a nonoperating mineral interest, such as a royalty interest, either in the same or in another tract or parcel of land.

In general, the area covered by each oil or gas lease is considered a separate tract or parcel of land. There are exceptions to this rule, however, as, for example, where a single lease covers noncontiguous areas. In such a case, each noncontiguous area is considered a separate tract or parcel of land.

Election to treat operating mineral interests as separate properties

Paragraph (2) of the new section 614(b) provides that if the taxpayer has more than one operating mineral interest in a single tract or parcel of land, he may elect, within the time and in the manner provided in paragraph (4) of section 614(b), to treat one or more of such operating mineral interests each as a separate property. The remaining operating mineral interests contained within such tract or parcel of land which the taxpayer does not elect to treat as separate properties are combined under the provisions of paragraph (1) of section 614(b) and treated as one property. Paragraph (2) of section 614(b) also provides that there can be only one combination of operating mineral interests in each tract or parcel of land. For example, the taxpayer may have operating mineral interests A, B, C, D, and E in a single tract or parcel of land. If he does not make the election contained in paragraph (2) of section 614(b), then all five interests will be combined and treated as one property. However the taxpayer may, instead, elect to treat operating mineral interests A, C, and E as three separate properties. The taxpayer would, as a result of such election, have four mineral properties; A, C, E, and a single property composed of B and D. The taxpayer may not combine B and D as one property, and A, C, and E as another property.

Paragraph (2) of the new section 614(b) also provides special rules for the treatment of operating mineral interests which are discovered or acquired by the taxpayer in the same tract or parcel of land after the taxable year for which an election to treat one or more interests in such tract or parcel as separate properties is made. If there is no combination of operating mineral interests in a particular tract or parcel of land, each operating mineral interest discovered or acquired in such tract or parcel after the taxable year for which an election is made will be treated as a separate property unless the taxpayer elects to combine such interest with another interest. If there is a combination of operating mineral interests in the tract or parcel of land, each operating mineral interest discovered or acquired in such tract or parcel after the taxable year for which an election was made under paragraph (2) will be treated as part of such combination unless the taxpayer elects to treat such interest as a separate property.

The operation of these provisions is illustrated by the following example, in which it is assumed that the taxpayer is on a calendar year basis:

Example.—Prior to 1964 a taxpayer acquired, and incurred development expenditures with respect to, the operating rights in a tract of land containing three oil deposits A, B, and C. For the taxable year 1964, he elects to treat his interests in the deposits as three separate properties. During the taxable year 1965, the taxpayer discovers and incurs development costs with respect to a fourth deposit, D. If the taxpayer makes no election relative to his interest in deposit D for 1965, such interest will thereafter be treated as a separate property. Alternatively, the taxpayer may make an election for 1965 to combine his interest in deposit D with any one (and only one) of the three other interests and to treat such combination as one property. If, for example, the taxpayer makes the election to combine deposit D with deposit C, any deposit in the same tract or parcel of land discovered or acquired by the taxpayer in subsequent years will become part of the combination of C and D if no election is made, or (if the taxpayer so elects) such subsequently discovered or acquired deposit may be treated as a separate property. After the combination of C and D is formed, deposits A and B, which were acquired or discovered prior to the formation of the combination and which were not included in such combination within the time prescribed, may not be included in that or any other combination.

Certain unitization or pooling arrangements

Paragraph (3)(A) of the new section 614(b) provides that, under regulations prescribed by the Secretary of the Treasury or his delegate, if one or more of the taxpayer's operating mineral interests (whether in the same or in different tracts or parcels of land) participate, under a voluntary or compulsory unitization or pooling agreement, in a single cooperative or unit plan of operation, then for the period of such participation they are treated as one property. A unitization or pooling agreement is an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis and further agree to share in production on a stipulated percentage or fractional basis regardless of from which interest or interests the oil is produced. In addition, in a situation

in which one person owns operating mineral interests in several leases, an agreement of such person with his several royalty owners to determine the royalties payable to each on a stipulated percentage basis regardless of from which lease or leases oil is obtained is also considered to be a unitization or pooling agreement.

Under the rule provided by paragraph (3)(A) of section 614(b), if, for example, a taxpayer exchanges his operating mineral interests in three leases for an interest in a unit plan of operation under which he will receive a fraction of the oil and gas produced from all the leases covered by such plan, his interest in the plan will be considered a single undivided interest in the unitized property rather than separate interests in the three contributed leases. This general rule applies whether or not the unitization or pooling agreement provides for a formal cross-conveyance of the properties between the parties.

Paragraph (3)(A)(ii) of section 614(b) also provides that during the period in which any of the taxpayer's operating mineral interests participates under a unitization or pooling agreement in a single cooperative or unit plan of operation, the application of paragraphs (1), (2), and (4) of section 614(b) in respect of such interests is suspended. Thus, paragraphs (1), (2), and (4) do not apply to operating mineral interests while they participate under a unitization or pooling agreement. However, such provisions do apply to any such interest prior to its participation under the unitization or pooling plan and after its removal from such plan. In the event paragraph (1) or (2) applied to any operating mineral interest prior to the time such interest commenced participation in a unitization or pooling plan, when it is removed from such plan such interest regains the status that it had prior to its participation in such plan. Moreover, the treatment of such interest under paragraph (1) or (2) prior to its participation in the unitization or pooling plan affects the treatment of any other interests in the same tract or parcel of land which do not participate under the plan. For example, assume that the taxpayer combines his interests in deposits A and B and treats them as one property, and that deposit B later participates under a unitization or pooling agreement. If another deposit, C, is subsequently discovered in the same tract of land and is not subject to the unitization agreement, then C will automatically be combined with A unless the taxpayer elects to treat it as a separate property. However, if neither paragraph (1) nor (2) has previously applied to an interest before it commences participation in a unitization or pooling plan, such interest becomes subject to the rules of paragraphs (1) and (2) if and when it is removed from the plan and any treatment applicable under either paragraph may be adopted within the time prescribed in section 614(b)(4).

These rules are illustrated by the following examples, in which it is assumed that the taxpayer is on a calendar year basis:

Example (1).—The taxpayer has four operating mineral interests (A, B, C, and D) in a tract or parcel of land during the taxable year 1964. Interest D commenced participation under a unitization agreement prior to 1964. The taxpayer has incurred expenditures for development with respect to the other three interests prior to 1964. Under the provisions of paragraph (1) of the new section 614(b), if the taxpayer makes no election relative to the three interests not participating under a unitization agreement, they will be combined and treated as one property. Interest D, which is participating in the

unitization plan, will not be affected by the provisions of paragraphs (1), (2), and (4) of section 614(b) until it is removed from such plan. At such time, if no election is made under paragraph (2) to treat interest D as a separate property within the time prescribed in paragraph (4), it becomes part of the combination of A, B, and C. However, the taxpayer may instead elect under paragraph (2) to treat interest D as a separate property.

Example (2).—Assume the same facts as in example (1), except that the taxpayer made the election provided in paragraph (2) of section 614(b) to treat each of the three interests (A, B, and C) not participating under the unitization agreement as a separate property. If the taxpayer makes no election within the time prescribed in paragraph (4) with respect to interest D when it is removed from the plan, such interest is treated as a separate property. However, the taxpayer may instead elect, under paragraph (2)(A) of section 614(b), to combine interest D with any one of interests A, B, or C and treat such combination as one property.

Example (3).—During the taxable year 1965, the taxpayer has three operating mineral interests (A, B, and C) in the same tract or parcel of land. Under the provisions of paragraphs (1) and (2) of section 614(b), A and B are combined into one property, and an election is made to treat C as a separate property. In 1966, interest B commences participation in a unitization plan of operation. In 1967, the taxpayer discovers another interest, D, in the same tract or parcel of land and he makes no election under paragraph (2) to treat D as a separate property. Accordingly, D is combined with A. The taxpayer may not combine D with C and treat such combination as one property because there can be only one combination of interests in each tract or parcel of land. In 1968, when interest B is removed from the unitization plan, it regains the status it had prior to the time it was unitized, that is, it is combined with A and D.

Limitation

Paragraph (3)(B) of the new section 614(b) provides that the operating mineral interests participating, under a voluntary unitization or pooling agreement, in a single cooperative or unit plan of operation will be treated as one property for the period of such participation only if (1) all of the operating mineral interests covered by the agreement are in the same deposit, or in two or more deposits the joint development or production of which is logical from the standpoint of geology, convenience, economy, or conservation, and (2) all such participating interests are in tracts or parcels of land which are contiguous or in close proximity.

If a voluntary unitization or pooling agreement fails to meet the conditions prescribed by paragraph (3)(B) of section 614(b), then the operating mineral interests covered by the agreement will not be treated as a single property under paragraph (3)(A) of such section; all such interests are subject instead to the general rules and elections provided in paragraphs (1) and (2) of section 614(b).

The limitations provided by paragraph (3)(B) do not apply to any compulsory unitization or pooling arrangement, that is, an arrange-

ment which is required by the laws or rulings of any State or its agencies.

Special rules in the case of arrangements entered into in taxable years beginning before January 1, 1964

Paragraph (3)(C) of the new section 614(b) provides that if two or more of the taxpayer's operating mineral interests participate under a voluntary or compulsory unitization or pooling agreement entered into in any taxable year beginning before January 1, 1964, in a single cooperative or unit plan of operation, and the taxpayer for the last taxable year beginning before January 1, 1964, has treated such interests as two or more separate properties, such taxpayer may continue to treat such interests in a consistent manner for the period of such participation if it is determined that such treatment was proper under the law applicable to such taxable year. Thus, if a taxpayer, instead of treating his operating mineral interests which are presently participating in a unitization or pooling agreement as a single property, treated them as two or more separate properties for past taxable years, he may continue to so treat them as separate properties for the period in which they participate in the unitization or pooling agreement if it is determined that such treatment was proper under the law applicable to such past taxable years. The question of whether the taxpayer may treat his separate mineral interests which are participating in a unitization or pooling arrangement as separate properties rather than as one property is presently being litigated. (See *Belridge Oil Company*, 27 T.C. 1044 (1957) (nonacq. C.B. 1958–1, 7), aff'd 267 F. 2d 291 (9th Cir. 1959); *Earl V. Whitwell*, 28 T.C. 372 (1957), rev'd on other grounds, 257 F. 2d 548 (5th Cir. 1958); *Winfield Killam, et al.*, 39 T.C. 680 (1963).) No inference is to be drawn from this provision as to whether, under the law applicable to taxable years beginning before January 1, 1964, separate interests which participate in unitization or pooling agreements should be treated as one undivided interest or retain the status they had prior to participation.

Paragraph (3)(C) of section 614(b) does not apply to operating mineral interests which commence participation in a unitization or pooling plan in a taxable year beginning after December 31, 1963. The provisions of paragraph (3)(C) will apply to operating mineral interests only as long as they continue their participation in a unitization or pooling agreement entered into in a taxable year beginning before January 1, 1964.

Manner, time, and scope of election

Paragraph (4) of the new section 614(b) provides that the election in paragraph (2) of such section is to be made for each operating mineral interest (in the manner prescribed by the Secretary of the Treasury or his delegate by regulations) not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is later: The first taxable year beginning after December 31, 1963, or the first taxable year in which any expenditure for development or operation in respect of such operating mineral interest is made by the taxpayer after the

acquisition of such interest. Since the application of paragraph (4) of section 614(b) is suspended while an interest participates under a unitization or pooling agreement to which paragraph (3)(A) of such section applies, an expenditure is to be disregarded if it is made with respect to an interest at a time when such interest is participating under such an agreement. Thus, if a taxpayer makes his first expenditure for development or operation in respect of an operating mineral interest when it is participating under a unitization or pooling agreement, he is not required to make any election with respect to such interest while it is participating under the agreement. However, if the interest is later withdrawn from participation under the agreement, any election which the taxpayer wishes to make with respect to such interest under paragraph (2) of section 614(b) must be made for the first taxable year in which an expenditure for development or operation is made after the interest has been withdrawn from participation under the agreement. If an expenditure for development or operation is made with respect to an interest prior to the time it participates under a unitization or pooling agreement, any election which the taxpayer wishes to make with respect to such interest under paragraph (2) must be made for the taxable year of such expenditure even though the time for making the election occurs after the interest has commenced participation under the agreement.

For the purpose of determining the taxable year for which an election under paragraph (2) of section 614(b) should be made, expenditures for development include any intangible drilling or development costs within the purview of section 263(c) of the code. Delay rentals are not considered as expenditures for development. For purposes of paragraph (4) of section 614(b), the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest. Any property resulting from the application of the new section 614(b) (whether such property is composed of one interest or of several interests) is treated as a single property for all purposes of subtitle A of the code, and such treatment is binding on the taxpayer for the taxable year for which made and all subsequent taxable years.

Treatment of certain properties

Paragraph (5) of the new section 614(b) provides that if, on the day preceding the first day of the first taxable year beginning after December 31, 1963, the taxpayer has any operating mineral interests which he treats under section 614(d) as in effect before the amendments made by this section of the bill, such treatment will be continued and be deemed to have been adopted pursuant to paragraphs (1) and (2) of the new section 614(b).

The existing section 614(d) of the code provides that, in the case of oil and gas wells, a taxpayer may treat any property as if the Internal Revenue Code of 1939 continued to apply, and as if subsections (a) and (b) of the existing section 614 of the code had not been enacted. The new section 614(b) provides rules comparable to the treatment provided under the Internal Revenue Code of 1939, and new elections are not provided with respect to properties which have been treated under the existing section 614(d). Such properties will continue to be treated, for taxable years to which this section of the bill applies, in the manner in which they are presently being treated under section

614(d). Paragraph (5) of the new section 614(b) provides that such treatment adopted in prior years will be deemed to have been adopted pursuant to the provisions of paragraphs (1) and (2) of such section.

Elections which were made to combine interests under the existing section 614(d) will be binding for all taxable years to which section 217 of the bill applies even though under paragraph (4) of the new section 614(b) the time within which the election could be made relative to some of the interests has not elapsed. This situation results since under the existing section 614(d) the taxpayer has to decide the specific treatment relative to an interest for the first taxable year in which he has paid or incurred any exploration expenditure in respect of such interest. Under the new section 614(b), the election does not have to be made prior to the time expenditures are made for development or operation. For example, a taxpayer, who under the existing section 614(d) treats interests A, B, and C (located in the same tract or parcel of land) as separate properties, makes an expenditure for exploration in 1963 in respect of interest D (also located in the same tract or parcel of land). For that year he combines interest D with interest A and treats them as one property. In 1965, the taxpayer makes the first expenditure for development in respect of interest D. Under paragraph (5) of the new section 614(b), his treatment under the existing section 614(d) in 1963 is binding for all subsequent years, and he continues to treat A and D as one property.

Paragraph (5) is illustrated by the following examples, in which it is assumed that the taxpayer is on a calendar year basis:

Example (1).—The taxpayer acquired and incurred exploration costs in 1958 on four oil and gas interests (A, B, C, and D) contained within a single tract or parcel of land. In that year, under the provisions of the existing section 614(d) of the code, the taxpayer treated A and B as one property and C and D each as a separate property. In 1964, he discovers a fifth oil and gas interest, E, in the tract or parcel of land. Development costs are incurred relative to E in 1965. The taxpayer does not make the election provided in paragraph (2) of the new section 614(b) to treat E as a separate property within the time prescribed. Under the provisions of paragraph (5) of such section, the treatment of properties adopted by the taxpayer in 1958 under section 614(d) is deemed to have been adopted pursuant to the provisions of paragraphs (1) and (2) of the new section 614(b), and the application of paragraph (2)(B) of the new section 614(b) results in the combining of E with A and B.

Example (2).—The taxpayer acquired and incurred exploration costs in 1959 on oil and gas interests A, B, and C which are in the same tract or parcel of land. For that year, under the provisions of the existing section 614(d), he treated the three interests as one property. During 1961, interest C commenced participation under a unitization agreement. Interest C is removed from the unitization plan in 1965. Since interest C is considered to have been treated under section 614(d) on December 31, 1963, upon its removal from the unitization plan in 1965 such interest will again be combined with interests A and B and all three interests will be treated as one property.

(*b*) *Technical amendments.*—Subsection (b) of section 217 of the bill makes several technical amendments to section 614 of the code. The heading of section 614(c) (relating to 1958 special rules as to

operating mineral interests in mines) is amended by striking out "1958". Paragraph (5) of section 614(c), which contains a reference to the definition of "operating mineral interests", is repealed since such reference is no longer necessary. Section 614(d) (relating to 1939 code treatment with respect to operating mineral interests in the case of oil and gas wells) is stricken out, and a new section 614(d) containing the definition of the term "operating mineral interests" is inserted. This definition is the same as the definition provided in the existing section 614(b)(3). Section 614(e)(2) is amended by striking out "within the meaning of subsection (b)(3)".

(*c*) *Allocation of basis in certain cases.*—Subsection (c) of section 217 of the bill provides rules for determining the adjusted basis for each property formed under the provisions of the new section 614(b) of the code which was previously a part of an aggregation formed under the existing section 614(b). Since the term "property" as used in subsection (c) of section 217 of the bill includes combinations of interests in the same tract or parcel of land which a taxpayer, under the amendments made by subsection (a) of section 217 of the bill, treats as one property, the rules set forth in subsection (c) of section 217 will be used to determine the adjusted basis of any property which is formed under the provisions of the new section 614(b) of the code without the necessity of determining the adjusted basis of each interest which is included in such property.

Under the existing section 614(b) of the code, the taxpayer has an election to form one aggregation of operating mineral interests within each of its operating units. Each interest in an operating unit not aggregated is treated as a separate property. The operation of the new section 614(b) results in the dissolution of previously formed aggregations, and the formation of new properties (including combinations limited to the operating mineral interests contained within a single tract or parcel of land). Thus, it is necessary to allocate the adjusted basis of the old aggregation to the properties determined under the new section 614(b). Subsection (c) of section 217 of the bill provides both a "fair market value" rule and an "allocation of adjustments" rule for making such allocation. The fair market value rule applies with respect to any aggregation unless the allocation of adjustments rule is elected by the taxpayer within such time and in such manner as the Secretary of the Treasury or his delegate prescribes by regulations. The choice of methods of allocating the adjusted bases of aggregations is made on an aggregation-by-aggregation basis; that is, a taxpayer may use the fair market value rule for some of his aggregations and the allocation of adjustments rule for others.

Fair market value rule

Paragraph (1) of section 217(c) of the bill provides the general rule for making the allocation of adjusted basis. This paragraph provides that if the taxpayer has an existing section 614(b) aggregation, then the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each new property determined under the new section 614(b) all of which was previously included in the aggregation is determined by multiplying the adjusted basis of the aggregation by a fraction, the numerator of which is the fair market value of such new property and the denominator of which is the fair market

value of such aggregation. If one or more of the interests included in the new property was not included in the aggregation formed under existing law, the adjusted basis of such new property is the sum of (1) the adjusted basis (as of the day preceding the first day of the first taxable year beginning after December 31, 1963) of the interest or interests which were not included in the aggregation, plus (2) the adjusted basis of the interest or interests which were included in the aggregation, determined in accordance with the preceding sentence. For the purposes of these computations, the adjusted basis of the aggregation, the fair market value of the aggregation, and the fair market value of each new property (or part thereof) which was included in such aggregation are determined as of the day preceding the first day of the first taxable year which begins after December 31, 1963. The fair market value rule is illustrated by the following example, in which it is assumed that the taxpayer is on a calendar year basis:

Example.—The taxpayer for years prior to 1964, under the provisions of the existing section 614(b) of the code, aggregated and treated as one property mineral interests A, B, C, D, and E. Interests A, B, and E are contained within the same tract or parcel of land. On December 31, 1963, the adjusted basis of the aggregation was $24,000, and the fair market value of the aggregation was $45,000. For the taxable year 1964 the taxpayer, under the provisions of paragraphs (1) and (2) of the new section 614(b), combines interests A and B to form one property and elects to treat interest E as a separate property. As of December 31, 1963, the fair market value of the single property made up of interests A and B is $15,000, and the fair market value of interest E is $10,000. On January 1, 1964, the adjusted basis of the combined A and B property is $8,000, computed as follows: $\$24,000 \times \frac{\$15,000}{\$45,000}$. The adjusted basis of property E is $5,333, computed as follows: $\$24,000 \times \frac{\$10,000}{\$45,000}$. (The remaining $10,667 is attributable to interests C and D.)

Allocation of adjustments, etc.

Paragraph (2) of section 217(c) of the bill provides, at the election of the taxpayer, an alternative rule for allocating the adjusted basis of an aggregation which was formed under the existing section 614(b) to the properties formed under the new section 614(b). Under this alternative rule, the adjusted basis of each property formed under the provisions of new section 614(b) (as of the first day of the first taxable year beginning after December 31, 1963) all of which was included in an aggregation formed under existing law is the adjusted basis of the operating mineral interest or interests which make up such new property at the time such interest or interests were first included in the aggregation formed under existing law by the taxpayer, adjusted for that portion of those subsequent adjustments to the basis of the aggregation which are reasonably attributable to such interest or interests. If one or more of the interests included in the new property was not included in the aggregation formed under existing law, the adjusted basis of such new property is the sum of (1) the adjusted basis (as of the day preceding the first day of the first taxable year beginning after December 31, 1963) of the interest or interests which

were not included in the aggregation, plus (2) the adjusted basis of the interest or interests which were included in the aggregation, determined in accordance with the preceding sentence. Thus, if the taxpayer can, by records of production or some other method, reasonably allocate the adjustments reflected in the adjusted basis of the aggregation to the individual properties contained therein, such alternative method of allocation can be used to determine the adjusted basis of each property resulting from the application of the new section 614(b). The allocation of adjustments rule is illustrated by the following example, in which it is assumed that the taxpayer is on a calendar year basis:

Example.—The taxpayer for years prior to 1964, under the provisions of the existing section 614(b) of the code, aggregated and treated as one property operating mineral interests A and B (which were not contained within the same tract or parcel of land). The cost of each interest was $10,000. The total adjustments to the basis of the aggregation for taxable years prior to 1964 was $15,000 which is allocable to interests A and B in the amounts of $10,000 and $5,000, respectively. Thus, the adjusted basis of the aggregation (as of December 31, 1963) is $5,000 ($20,000 minus $15,000). The adjusted bases (as of January 1, 1964) of properties A and B, computed under the allocation of adjustments method, are $0 and $5,000, respectively

Paragraph (2) of section 217(c) of the bill further provides that if the total of the adjusted bases of the interests included in an aggregation exceeds the adjusted basis of the aggregation (as of the day preceding the first day of the first taxable year which begins after December 31, 1963), the adjusted bases of the properties which include such interests will be adjusted, under regulations prescribed by the Secretary of the Treasury or his delegate, so that the total of the adjusted bases of such interests equals the adjusted basis of the aggregation. This rule is illustrated by the following example, in which it is assumed that the taxpayer is on a calendar year basis:

Example.—The taxpayer for years prior to 1964, under the provisions of the existing section 614(b) of the code, aggregated and treated as one property mineral interests A, B, C, and D (of which only A and B are contained within the same tract or parcel of land). The cost of each interest was $10,000. The total adjustments to the basis of the aggregation for taxable years prior to 1964 were $25,000 which is allocable to interests A, B, C, and D in the amounts of $5,000, $0, $15,000, and $5,000, respectively. Thus, the adjusted basis of the aggregation (as of December 31, 1963) is $15,000 ($40,000 minus $25,000). If the taxpayer, during 1964 and subsequent years, treats interests A and B as one property and interests C and D each as a separate property, the application of the rule set forth in the first sentence of paragraph (2) of section 217(c) of the bill would result in an adjusted basis of $15,000 ($20,000 minus $5,000) for the property made up of interests A and B, and bases of $0 ($10,000 minus $15,000) and $5,000 ($10,000 minus $5,000) for properties C and D, respectively. Since the total of these adjusted bases ($20,000) exceeds the adjusted basis of the aggregation itself ($15,000), the bases of the properties formed by the application of new section 614(b) will be reduced under regulations prescribed by the Secretary of the Treasury or his delegate, so that such adjusted bases total $15,000.

Paragraph (3) of section 217(c) of the bill contains definitions of certain terms used in such section.

(*d*) *Effective date.*—Subsection (d) of section 217 of the bill provides that the amendments made by subsections (a) and (b) of such section apply to taxable years beginning after December 31, 1963.

SECTION 218. TREATMENT OF CERTAIN IRON ORE ROYALTIES

(*a*) *In general.*—Subsection (a) of section 218 of the bill amends sections 631(c), 1231(b)(2), and 272 of the code to grant, in the case of certain disposals of iron ore with a retained economic interest, the same treatment which is now available in the case of certain disposals of coal with a retained economic interest. Under such treatment, the gain or loss attributable to such disposals of iron ore is treated as gain or loss from the sale of property used in the trade or business (as defined in section 1231(b) of the code). However (under the amendments made by section 219 of the bill), any such gain is treated as a class B capital gain, even though the iron ore is held for more than 2 years prior to its disposal.

Amendment of section 631(c)

Paragraph (1) of section 218(a) of the bill amends section 631 of the code (relating to disposal of coal with a retained economic interest) to extend the benefits of that section to iron ore. The existing section 631(c) provides that in the case of the disposal of coal (including lignite) held for more than 6 months before such disposal by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 of the code (relating to disposal of coal) is considered as though it were a gain or loss, as the case may be, on the sale of such coal. All of the provisions of section 631(c) which presently apply to the disposal of coal with a retained economic interest will also apply to the disposal of iron ore with a retained economic interest. Iron ore is any ore which is used as a source of iron, including but not limited to taconite and jaspilite. If an ore is used, or sold for use, as a source of iron and another mineral or minerals, only the part of the amount realized which is attributable to the iron is considered to be an amount realized from the disposal of iron ore.

Amendment of section 1231(b)

Paragraph (2) of section 218(a) of the bill amends section 1231(b) of the code (defining property used in the trade or business) to include iron ore, with respect to which section 631 applies, within the definition of property used in the trade or business. The effect of this amendment is to extend the benefits of section 1231 to a gain or loss on the disposal or iron ore with a retained economic interest. Any such gain is treated (under the amendments made by section 219 of the bill) as a class B capital gain, even though the iron ore is held for more than 2 years prior to its disposal.

Amendment of section 272

Paragraph (3) of section 218(a) of the bill amends section 272 of the code to provide, in the case of expenditures made in connection with the disposal of iron ore with a retained economic interest, the same treatment as is provided for coal under existing law. The existing section 272 provides that, where the disposal of coal is covered by section 631, no deduction is allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs or to the preservation of the economic interest retained under such contract; except that if in any taxable year such expenditures plus the adjusted depletion basis of the coal disposed of in such taxable year exceed the amount realized under such contract, such excess, to the extent not availed of as a reduction of gain under section 1231, is a loss deductible under section 165(a) of the code. Section 272 does not apply to any taxable year during which there is no income under the contract.

(*b*) *Clerical amendments.*—Subsection (b) of section 218 of the bill makes the various clerical and conforming amendments to the code which are required as a result of the amendments made by subsection (a) of such section.

(*c*) *Effective date.*—Subsection (c) of section 218 of the bill provides that the amendments made by such section apply to iron ore mined in taxable years beginning after December 31, 1963.

SECTION 219. CAPITAL GAINS AND LOSSES

(*a*) *Alternative tax, etc.*—Under existing law, there are two categories of capital gains and losses which apply to all taxpayers: (1) Short-term capital gain or loss (gain or loss from the sale or exchange of a capital asset held for not more than 6 months) and (2) long-term capital gain or loss (gain or loss from the sale or exchange of a capital asset held for more than 6 months). The amendments made by section 219(a) of the bill provide, in the case of taxpayers other than corporations, for the splitting of the long-term capital gain or loss category into two categories: (1) Class B capital gain or loss (gain or loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years), and (2) class A capital gain or loss (gain or loss from the sale or exchange of a capital asset held for more than 2 years). Thus, for taxable years beginning after December 31, 1963, there will be three categories of capital gains and losses applicable to taxpayers other than corporations: Short-term, class B, and class A. Corporate taxpayers can have only short-term and long-term capital gains and losses since the changes relate only to the taxation of taxpayers other than corporations.

The amendments made by section 219(a) of the bill are applicable in the case of a capital gain which is properly reportable by a taxpayer (other than a corporation) on the installment basis under section 453 of the code for a taxable year to which such amendments apply even though the property was sold or otherwise disposed of in a taxable year to which such amendments do not apply.

Alternative tax

Paragraph (1)(A) of section 219(a) of the bill amends section 1201(b) of the code (relating to alternative tax on taxpayers other than

corporations), which presently imposes, in certain instances, an alternative tax on the excess of the net long-term capital gain over the net short-term capital loss of a taxpayer other than a corporation. This alternative tax is 25 percent of such excess. Section 1201(b), as amended, imposes, in certain instances, an alternative tax which taxes the taxpayer's capital gains at a rate equal to 21 percent of his adjusted class A capital gain and 25 percent of his adjusted class B capital gain. The terms "adjusted class B capital gain" and "adjusted class A capital gain" are defined in paragraphs (9) and (10) of section 1222(c) of the code, as amended by the bill. If a taxpayer other than a corporation has, for any taxable year, both adjusted class B capital gain and adjusted class A capital gain, the determination as to whether the alternative tax under section 1201(b) applies must be made by applying the applicable alternative rate to each class of capital gain, and the taxpayer may not compute his tax for only one of the two classes of capital gains under section 1201(b).

Deduction for capital gains

Paragraph (1)(B) of section 219(a) of the bill amends section 1202 of the code (relating to deduction for capital gains), which presently provides that a taxpayer other than a corporation is allowed for any taxable year a deduction from gross income of 50 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Section 1202(a), as amended, provides a deduction from gross income for a taxpayer other than a corporation equal to the sum of 60 percent of the adjusted class A capital gain and 50 percent of the adjusted class B capital gain.

Section 1202(b), as amended, retains a provision of existing law which provides that, in the case of an estate or trust, the deduction under section 1202(a) is computed by excluding the portion of the gains for the taxable year from sales or exchanges of capital assets which is includible under sections 652 and 662 of the code (relating to inclusions of amounts in gross income of beneficiaries of trusts) by income beneficiaries in their gross incomes as gain derived from the sale or exchange of capital assets.

Definitions

Paragraph (1)(C) of section 219(a) of the bill amends section 1222 of the code, which defines various terms relating to short-term and long-term capital gains and losses. Section 1222 as amended has been divided into four subsections which relate to (1) terms applicable to all taxpayers, (2) terms applicable to corporations, (3) terms applicable to taxpayers other than corporations, and (4) rules for reducing net capital gains by capital losses.

SECTION 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES

(*a*) *Terms applicable to all taxpayers.*—Section 1222(a) contains definitions of terms applicable to all taxpayers. These terms are "short-term capital gain," "short-term capital loss," "net short-term capital gain," and "net short-term capital loss." These terms and their definitions are the same as those in existing law.

(*b*) *Terms applicable to corporations.*—Section 1222(b) contains definitions of terms applicable to corporations. These terms are "long-term capital gain," "long-term capital loss," "net long-term

capital gain," "net long-term capital loss," "net capital gain," and "net capital loss." These terms and their definitions are the same as those in existing law, although their application is limited to corporations.

(c) *Terms applicable to taxpayers other than corporations.*—Section 1222(c) contains definitions of terms applicable to taxpayers other than corporations. These terms and their definitions are new. The terms are "class B capital gain," "class B capital loss," "class A capital gain," "class A capital loss," "net class B capital gain," "net class B capital loss," "net class A capital gain," "net class A capital loss," "adjusted class B capital gain," and "adjusted class A capital gain."

Class B capital gain or loss is defined as gain or loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years, to the extent such gain is taken into account in computing gross income or to the extent such loss is taken into account in computing taxable income. Class A capital gain or loss is defined as gain or loss from the sale or exchange of a capital asset held for more than 2 years, to the extent such gain is taken into account in computing gross income or to the extent such loss is taken into account in computing taxable income.

Net class B capital gain is the excess of the class B capital gains for the taxable year over the class B capital losses for such year. Net class B capital loss is the excess of the class B capital losses for the taxable year over the class B capital gains for such year. Net class A capital gain is the excess of the class A capital gains for the taxable year over the class A capital losses for such year. Net class A capital loss is the excess of the class A capital losses for the taxable year over the class A capital gains for such year.

Adjusted class B or adjusted class A capital gain is the net class B or net class A capital gain, as the case may be, for the taxable year reduced by the capital losses which reduce such net gain as provided in subsection (d) of section 1222.

(d) *Rules for reducing net capital gains by capital losses.*—Section 1222(d) provides rules by which net class B and net class A capital gains are reduced by capital losses in arriving at adjusted class B and adjusted class A capital gains. Also, these rules are applicable for purposes of reducing any net short-term capital gain realized by a taxpayer (other than a corporation) by any net class B or net class A capital loss. Furthermore, these rules are applicable in computing a net short-term, net class B, or net class A capital loss for purposes of the capital loss carryover under section 1212(b). The rules are to be applied in order; first the rule in paragraph (1) of section 1222(d), then the rule in paragraph (2) of such section, and last the rule in paragraph (3) of such section. The rules are (1) a net class A capital loss reduces first any net class B capital gain and then any net short-term capital gain, (2) a net class B capital loss reduces first any net class A capital gain and then any net short-term capital gain, and (3) a net short-term capital loss reduces first any net class B capital gain and then any net class A capital gain. If the taxpayer has a net capital gain in only one category and a net capital loss in one other category, the gain is reduced by the loss.

The application of these rules is illustrated as follows:

Example (1).—X, a calendar-year taxpayer other than a corporation, has for 1964 a $600 net class A capital gain, a $200 net class B capital loss, and a $500 net short-term capital loss. Under the provisions of section 1222(d), X's $600 net class A capital gain is reduced first by his $200 net class B capital loss and the remaining $400 net class A capital gain is then reduced by his $500 net short-term capital loss. Thus, for 1964, X has only a $100 net short-term capital loss which does not reduce capital gains. If for 1964 X had an $800 net class A capital gain instead of a $600 net class A capital gain, X would have a $100 adjusted class A capital gain.

Example (2).—Y, a calendar-year taxpayer other than a corporation, has for 1964 a $700 net class B capital gain, a $400 net class A capital loss, and a $600 net short-term capital loss. Under the provisions of section 1222(d), Y's $700 net class B capital gain is reduced first by his $400 net class A capital loss, and the remaining $300 net class B capital gain is then reduced by his $600 net short-term capital loss. Thus, for 1964, Y has only a $300 net short-term capital loss which does not reduce capital gains.

Example (3).—Z, a calendar-year taxpayer other than a corporation, has for 1964 a $700 net short-term capital gain, an $800 net class A capital loss, and a $100 net class B capital loss. Under the provisions of section 1222(d), Z's $700 net short-term capital gain is reduced by his $800 net class A capital loss. Thus, for 1964, Z has a $100 net class A capital loss which does not reduce capital gains and a $100 net class B capital loss which does not reduce capital gains. If for 1964 Z had a $1,000 net short-term capital gain instead of a $700 net short-term capital gain, his $1,000 net short-term capital gain would have first been reduced by his $800 net class A capital loss and the remaining $200 net short-term capital gain would then be reduced by his $100 net class B capital loss.

SECTION 219. CAPITAL GAINS AND LOSSES (Continued)

Property used in the trade or business and involuntary conversions

Paragraph (2) of section 219(a) of the bill amends section 1231 of the code (relating to property used in a trade or business), which presently provides long-term capital gain and loss treatment for the recognized gains and losses from sales, exchanges, and certain conversions of property used in the trade or business (as defined in sec. 1231(b)), and for certain other recognized gains and losses, if the total of such gains exceeds the total of such losses. Included in the definition of the term "property used in the trade or business" are (1) timber and coal with respect to which section 631 applies, (2) certain livestock, and (3) certain unharvested crops.

Section 1231 is amended by this paragraph of the bill to accommodate the two new categories of capital gains and losses applicable to taxpayers other than corporations for taxable years beginning after December 31, 1963, and to provide that, with respect to taxpayers other than corporations, the gain or loss on certain property used in the trade or business is to be considered class B capital gain or loss (if the gains to which sec. 1231 applies exceed the losses to which such section applies) whether or not the holding period of such property

exceeds 2 years. In addition, certain provisions of section 1231 are rearranged.

Subparagraph (A) of this paragraph of the bill amends section 1231(a) of the code. Under the amendment, section 1231(a) retains the rule of existing law that if the gains to which section 1231 applies exceed the losses to which it applies, such gains and losses are treated as gains and losses from sales or exchanges of capital assets. As under existing law, corporations will receive long-term capital gain or loss treatment on sales, exchanges, or conversions to which section 1231 applies. Taxpayers other than corporations will treat such gains and losses as class A or class B capital gains and losses depending upon the holding periods of the particular items of property sold, exchanged, or converted. Section 1231(a) as amended retains the rule of existing law that if the gains to which section 1231 applies do not exceed the losses to which it applies, such gains and losses are not treated as gains and losses from sales or exchanges of capital assets.

Subparagraph (B) of this paragraph of the bill adds to section 1231 of the code a new subsection (c), providing special rules. Several rules found in the existing section 1231(a) are continued in paragraphs (1) and (2) of section 1231(c).

Subparagraph (A)(i) of paragraph (1) of the new section 1231(c) restates the rule (found in the existing sec. 1231(a)(1)) which provides that the gains which are included in determining whether gains exceed losses (for purposes of sec. 1231(a)) are those gains (described in sec. 1231(a)) which are taken into account in computing gross income but only to the extent so taken into account. Subparagraph (A)(ii) of paragraph (1) provides that gains, otherwise includible for purposes of section 1231(a), are included only to the extent they are not required by any provision of subtitle A of the code (other than sec. 1231) to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Thus, for example, to the extent that gain from the sale or exchange of property is required under section 1245 (or sec. 1250, added by sec. 220 of the bill) to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, such gain is not included for purposes of section 1231(a). Subparagraphs (B) and (C) of paragraph (1) of the new section 1231(c), and paragraph (2) of such section, restate existing law.

Paragraph (3) of the new section 1231(c) provides that, in the case of a taxpayer other than a corporation, if gain or loss from the sale, exchange, or conversion of certain property is considered (under sec. 1231(a)) as gain or loss from the sale or exchange of a capital asset, such gain or loss is to be considered class B capital gain or loss, even if such property was held for more than 2 years. Properties to which the preceding sentence relates are (1) timber, coal, and iron ore with respect to which section 631 of the code, as amended by section 218 of the bill, applies, (2) livestock (not including poultry), regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition, and (3) an unharvested crop on land used in the trade or business and held for more than 6 months, which is sold, exchanged, or converted with the land at the same time and to the same person. However, if gain or loss from the sale, exchange, or conversion of timber, coal, or iron ore properties would qualify for capital gain treatment without

the benefit of section 631, then such gain or loss to which section 1231(a) applies is, in the case of a taxpayer other than a corporation, treated as class A capital gain or loss if the property has been held for more than 2 years.

Certain distributions under employees' trusts and annuity plans

Paragraph (3)(A) of section 219(a) of the bill amends section 402(a) of the code (relating to taxability of beneficiary of exempt trust) to provide that certain distributions which under existing law are accorded long-term capital gain treatment are to be accorded class B capital gain treatment. In addition, section 402(a) as amended provides that gain on the sale or other disposition of securities of the employer, to the extent of the net unrealized appreciation attributable to such securities which was not taxed when the securities were distributed or made available, is considered as class B capital gain. Any excess amount realized upon the sale of such securities (over and above the distributee's basis plus the previously unrealized appreciation) is a short-term, class B, or class A capital gain, depending on the length of time the distributee has held the securities. The amendments made by paragraph (3)(A) of section 219(a) of the bill to section 402(a) of the code apply (under par. (3)(C) of sec. 219(a)) with respect to distributions in taxable years of the distributee, and with respect to securities sold or otherwise disposed of in taxable years, beginning after December 31, 1963.

Paragraph (3)(B) of section 219(a) of the bill amends section 403(a)(2)(A) of the code (relating to capital gains treatment for certain distributions), which presently provides rules (comparable to rules in sec. 402) which accord long-term capital gain treatment for certain total distributions made under a qualified annuity plan. Section 403(a)(2)(A) as amended provides that distributions under a qualified annuity plan which are extended capital gain treatment are to be accorded class B capital gain treatment. The amendments made by paragraph (3)(B) to section 403 (a)(2)(A) of the code apply (under par. (3)(C)) with respect to amounts paid in taxable years of the distributee beginning after December 31, 1963.

Sale or exchange of patents

Paragraph (4) of section 219(a) of the bill amends section 1235(a) of the code (relating to the sale or exchange of patents) to reflect the new capital gain and loss treatment accorded to taxpayers other than corporations. New sentences are added at the end of such section to provide that gain or loss on a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or of an undivided interest therein which includes a part of all such rights, by an individual whose efforts created such property is treated as class B capital gain or loss, regardless of the length of time such property is held. In the case of an individual who is described as a holder in section 1235(b)(2), any gain or loss on such a transfer is treated as a class B capital gain or loss if such property is held for not more than 2 years (even if held for less than 6 months), or as a class A capital gain or loss if such property is held for more than 2 years.

Employee termination payments

Paragraph (5) of section 219(a) of the bill amends section 1240 of the code (relating to taxability to employee of termination payments)

by striking out "6 months" and inserting in lieu thereof "6 months but not more than 2 years" so as to limit the payments under such section to class B capital gain treatment.

(*b*) *Unlimited capital loss carryover.*—Subsection (b) of section 219 of the bill amends section 1212 of the code (relating to capital loss carryover). Under the existing provisions of section 1212, if a taxpayer has a net capital loss for a taxable year, the amount thereof is a short-term capital loss in each of the 5 succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year.

Section 1212(a) as designated and amended by this section of the bill retains all of the existing substantive rules of section 1212 but provides that these rules apply only with respect to corporate taxpayers.

Subsection (b) of section 219 of the bill adds to section 1212 of the code a new subsection (b) relating to taxpayers other than corporations. Paragraph (1) of the new section 1212(b) provides that to the extent a taxpayer other than a corporation has a net short-term, net class B, or net class A capital loss which does not, under the rules provided in section 1222(d), reduce capital gains, such loss, reduced as provided in paragraph (2) of the new section 1212(b), is carried forward and treated in the succeeding taxable year as a short-term, class B, or class A capital loss, as the case may be, sustained in such succeeding year. The portion of a net short-term, net class B, or net class A capital loss which is in excess of the capital gains which such loss reduces (as determined under the proper application of the rules) is a loss which, for purposes of section 1212(b), does not reduce capital gains.

Section 1211(b) of the code limits, in the case of a taxpayer other than a corporation, the capital loss deduction (otherwise allowable under sec. 165 of the code) for any taxable year to an amount equal to the taxpayer's capital gains for such year plus the lesser of $1,000 or his taxable income (computed as therein provided). Under paragraph (2) of the new section 1212(b), the sum allowable under section 1211(b), to the extent it exceeds capital gains, reduces, first, any net short-term capital loss available to be carried over to the succeeding year, then any net class B capital loss available to be carried over to the succeeding year, and, finally, any net class A capital loss available to be carried over to the succeeding taxable year.

The foregoing is illustrated by the following example:

Example.—X, a calendar-year taxpayer other than a corporation, has capital gains and losses for 1964 as follows: $1,200 net class A capital loss, $600 net class B capital loss, and $400 net short-term capital gain. Under the provisions of section 1222(d) of the code, the $400 net short-term capital gain is reduced by the $1,200 net class A capital loss, leaving an $800 net class A capital loss which does not reduce capital gains. Assuming that X had taxable income (determined as provided in sec. 1211(b) of the code) of $1,000 for 1964, such $1,000 first offsets the $600 net class B capital loss and the remaining $400 then offsets the $800 net class A capital loss, leaving a $400 net class A capital loss which may be carried forward and treated as a class A capital loss sustained in 1965.

Paragraph (3) of the new section 1212(b) provides that a net capital loss for a taxable year beginning before January 1, 1964, is to be determined under the law applicable to such taxable year, and the amount of any such capital loss so determined (which such applicable law allows to be carried over to the first taxable year of the taxpayer beginning after December 31, 1963) is to be treated as a short-term capital loss occurring in such first taxable year beginning after December 31, 1963.

(*c*) *Technical amendments.*—Subsection (c) of section 219 of the bill contains technical amendments to various provisions of the code. Most of these amendments merely conform the terminology of the provisions involved to the new classifications of capital gains and losses for taxpayers other than corporations. The remaining amendments are discussed below.

Taxation of regulated investment companies and their shareholders

Paragraph (7)(A) of section 219(c) of the bill amends subparagraphs (B) and (C) of section 852(b)(3) of the code (relating to taxation of regulated investment companies and their shareholders). Subparagraph (B) of section 852(b)(3) presently provides that a shareholder of a regulated investment company must treat a capital gain dividend as long-term capital gain. Subparagraph (C) of such section defines a capital gain dividend as any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. Subparagraph (C) further provides that a shareholder may not treat as long-term capital gain an amount in excess of his proportionate share of the excess of the company's net long-term capital gain over its net short-term capital loss. These rules apply to corporate as well as noncorporate shareholders.

Subparagraph (B) of section 852(b)(3) of the code, as amended by this paragraph of the bill, provides that a capital gain dividend is to be treated by a shareholder other than a corporation as class A or class B capital gain to the extent so designated by the company. It also provides that corporate shareholders must treat a capital gain dividend as long-term capital gain. Subparagraph (C) of section 852(b)(3), as amended, defines a capital gain dividend as any dividend, or part thereof, which is designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year as a distribution of class A or class B capital gain. Thus, a regulated investment company is to indicate its capital gain dividends by designating portions of its distributions as class A or class B capital gain; however, the amounts so designated are to be treated by corporate shareholders as long-term capital gain. Subparagraph (C), as amended, also retains the rule of existing law that a shareholder may not treat as long-term capital gain an amount in excess of his proportionate share of the excess of the company's net long-term capital gain over its net short-term capital loss but limits the applicability of this rule to corporate shareholders. In the case of a shareholder other than a corporation, subparagraph (C), as amended, provides that if the company designates as class A or class B capital gain amounts which exceed its adjusted class A or adjusted class B capital gain, such shareholder is to treat only his proportionate share of such adjusted class A or adjusted class B capital gain as class A or class B

capital gain, respectively. For purposes of subparagraph (C), the company's adjusted class A and adjusted class B capital gains are computed as though the company were a taxpayer other than a corporation (except that the corporate capital loss carryover rules apply in lieu of the capital loss carryover rules applicable to taxpayers other than corporations).

Paragraph (7)(B) of section 219(c) of the bill amends clauses (i), (ii), and (iii) of section 852(b)(3)(D) of the code to conform the terminology of such clauses to the new classifications of capital gains applicable to taxpayers other than corporations.

Paragraph (7)(C) of section 219(c) of the bill amends paragraph (4) of section 852(b) of the code. In general, paragraph (4) of section 852(b) presently provides that when a person who holds a share in a regulated investment company for less than 31 days (1) incurs a loss on the sale or exchange of such share and (2) is required, with respect to such share, to treat any amount as long-term capital gain, then such loss, but not in excess of the amount required to be treated as long-term capital gain, is treated as long-term capital loss. Paragraph (4) as amended retains the present rules for corporate shareholders. It also provides that if a shareholder other than a corporation incurs a loss on the sale or exchange of such a share and is required, with respect to such share, to treat any amount as class A or class B capital gain, then the amount of such loss, but not in excess of the amount treated as class A or class B capital gain, is treated as class A or class B capital loss, respectively. If the sum of such class A and class B capital gains exceeds the loss on the sale or exchange of such share, a portion of such loss equal to the proportion which such class A capital gain bears to the sum of such class A and class B capital gains is a class A capital loss; and the remainder of such loss is a class B capital loss.

Taxation of real estate investment trusts and their beneficiaries

Paragraph (8)(A) of section 219(c) of the bill amends subparagraphs (B) and (C) of section 857(b)(3) of the code (relating to taxation of real estate investment trusts and their beneficiaries). Subparagraph (B) of section 857(b)(3) presently provides that a shareholder of (or a holder of a beneficial interest in) a real estate investment trust must treat a capital gain dividend as long-term capital gain. Subparagraph (C) of such section defines a capital gain dividend as any dividend, or part thereof, which is designated by the trust as a capital gain dividend in a written notice mailed to its shareholders before the expiration of 30 days after the close of its taxable year. Subparagraph (C) further provides that a shareholder may not treat as long-term capital gain an amount in excess of his proportionate share of the excess of the trust's net long-term capital gain over its net short-term capital loss. These rules apply to corporate as well as noncorporate shareholders.

Subparagraph (B) of section 857(b)(3) of the code, as amended by this paragraph of the bill, provides that a capital gain dividend is to be treated by a shareholder other than a corporation as class A or class B capital gain to the extent so designated by the trust. It also provides that corporate shareholders must treat a capital gain dividend as long-term capital gain. Subparagraph (C) of section 857(b)(3), as amended, defines a capital gain dividend as any dividend,

or part thereof, which is designated by the trust in a written notice mailed to its shareholders before the expiration of 30 days after the close of its taxable year as a distribution of class A or class B capital gain. Thus, a real estate investment trust is to indicate its capital gain dividends by designating portions of its distributions as class A or class B capital gain; however, the amounts so designated are to be treated by corporate shareholders as long-term capital gain. Subparagraph (C) as amended also retains the rule of existing law that a shareholder may not treat as long-term capital gain an amount in excess of his proportionate share of the excess of the trust's net long-term capital gain over its net short-term capital loss but limits the applicability of this rule to corporate shareholders. In the case of a shareholder other than a corporation, subparagraph (C) as amended provides that if the trust designates as class A or class B capital gain amounts which exceed its adjusted class A or adjusted class B capital gain, such shareholder is to treat only his proportionate share of such adjusted class A or adjusted class B capital gain as class A or class B capital gain, respectively. For purposes of subparagraph (C), the adjusted class A and adjusted class B capital gains are computed as though the trust were a taxpayer other than a corporation (except that the corporate capital loss carryover rules apply in lieu of the capital loss carryover rules applicable to taxpayers other than corporations).

Paragraph (8)(B) of section 219(c) of the bill amends paragraph (4) of section 857(b) of the code. In general, paragraph (4) of section 857(b) presently provides that when a person who holds a share in a real estate investment trust for less than 31 days (1) incurs a loss on the sale or exchange of such share and (2) is required, with respect to such share, to treat any amount as long-term capital gain, then such loss, but not in excess of the amount required to be treated as long-term capital gain, is treated as long-term capital loss. Paragraph (4) as amended retains the present rules for corporate shareholders. It also provides that if a shareholder other than a corporation incurs a loss on the sale or exchange of any such share held for less than 31 days and is required, with respect to such share, to treat any amount as class A or class B capital gain, then the amount of such loss, but not in excess of the amount treated as class A or class B capital gain, is treated as class A or class B capital loss, respectively. If the sum of such class A and class B capital gains exceeds the loss on the sale or exchange of such share, a portion of such loss equal to the proportion which such class A capital gain bears to the sum of such class A and class B capital gains is a class A capital loss; and the remainder of such loss is a class B capital loss.

Gains and losses from short sales

Paragraph (10)(A) of section 219(c) of the bill amends section 1233(b) of the code (relating to gains and losses from short sales). In general, section 1233(b) presently provides that if, on the date of a short sale of a capital asset, substantially identical property has been held by the taxpayer for not more than 6 months (or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof), any gain on the closing of the short sale is considered short-term capital gain, and the holding period of such substantially identical property begins

on the date of the closing of such short sale. Section 1233(b), as amended by this paragraph of the bill, retains the present rules and provides for the situation in which a taxpayer other than a corporation has held on the date of a short sale of a capital asset substantially identical property for more than 6 months but not more than 2 years. In such a case, any gain on the closing of such short sale is treated as gain on the sale or exchange of a capital asset held for more than 6 months but not more than 2 years. Also, the holding period of such substantially identical property begins on the date of the closing of the short sale.

Paragraph (10)(B) of section 219(c) of the bill amends section 1233(d) of the code. In general, section 1233(d) presently provides that if, on the date of a short sale of a capital assset, substantially identical property has been held by the taxpayer for more than 6 months, then any loss on the closing of such short sale is to be considered as a loss from the sale or exchange of a capital asset held for more than 6 months. Section 1233(d) as amended by this paragraph of the bill retains the existing provisions as they relate to corporations. With respect to taxpayers other than corporations, section 1233(d) as amended provides that if substantially identical property is held on the date of the short sale of a capital asset and such substantially identical property has been held by the taxpayer (1) for more than 2 years, any loss on the closing of the short sale is considered as loss on the sale or exchange of a capital asset held for more than 2 years, or (2) for more than 6 months but not more than 2 years, any loss on the closing of the short sale is considered as loss on the sale or exchange of a capital asset held for more than 6 months but not more than 2 years.

Paragraph (10)(C) of section 219(c) of the bill amends paragraph (1) of section 1233(e) of the code. Paragraph (1) of section 1233(e) presently provides that the provisions of subsection (b)(1) or (d) of section 1233 (discussed above) do not apply to the gain or loss, respectively, on any quantity of property used to close a short sale which is in excess of the substantially identical property referred to in such subsections. Paragraph (1) of section 1233(e) as amended by this paragraph of the bill continues the existing rules but makes changes to conform with the changes made in section 1233 (b) and (d) by paragraphs (10)(A) and (10)(B) of section 219(c) of the bill (discussed above).

Paragraph (10)(D) of section 219(c) of the bill amends subparagraph (A) of section 1233(e)(4) of the code. In general, subparagraph (A) of section 1233(e)(4) presently provides that if a dealer in securities holds, on the date of a short sale of stock, substantially identical property which is a capital asset in his hands, and such property has been held by the dealer for not more than 6 months, and if such short sale is closed more than 20 days after the date on which it was made, then the holding period of such substantially identical property begins on the date of the closing of the short sale. Subparagraph (A) of such section as amended by this paragraph of the bill retains this rule for corporate dealers in securities and applies it in the case of noncorporate dealers in securities who, on the date of the short sale, have held substantially identical property for not more than 2 years.

Paragraph (10)(E) of section 219(c) of the bill makes a clerical change in section 1233(f) of the code to conform the language of such section to an organizational change made in section 1233(b)(2).

Election by foreign investment companies to distribute income currently

Paragraph (11)(A) of section 219(c) of the bill amends subparagraph (B) of section 1247(a)(1) of the code (relating to election by foreign investment companies to distribute income currently). Section 1247(a) presently provides, in general, that if a foreign investment company elects, on or before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, (1) to distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation, (2) to designate in a timely mailed written notice to its shareholders the pro rata amount of the excess of the company's net long-term capital gain over its net short-term capital loss for the taxable year and the portion thereof which is being distributed, and (3) to furnish certain information to the Secretary of the Treasury or his delegate, then section 1246 of the code (relating to gain on foreign investment company stock) does not apply with respect to the qualified shareholders (see sec. 1247(c)) of such company during any taxable year to which such election applies. Subparagraph (B) of section 1247(a)(1) as amended by this paragraph of the bill provides that the company must designate to its shareholders the pro rata amount for the taxable year of the adjusted class A and adjusted class B capital gain (determined as though such company were a taxpayer other than a corporation, except that the corporate capital loss carryover rules apply in lieu of the capital loss carryover rules applicable to taxpayers other than corporations) and the portions thereof which are being distributed.

Subparagraphs (B), (C), and (D) of paragraph (11) of section 219(c) of the bill amend section 1247(a)(2)(A)(i), section 1247(a)(2)(C), and section 1247(c)(2) of the code, respectively, to conform the terminology of such sections to the new classifications of capital gains for taxpayers other than corporations.

Paragraph (11)(E) of section 219(c) of the bill amends section 1247(d) of the code. In general, section 1247(d) presently provides that every qualified shareholder (within the meaning of sec. 1247(c)) of the company for any taxable year with respect to which an election pursuant to section 1247(a) is in effect must include, in computing his long-term capital gains, his pro rata share of both the distributed and undistributed portion of the excess of the net long-term capital gain over the net short-term capital loss for such taxable year of such company. Section 1247(d) as amended by this paragraph of the bill retains the present rule for corporate shareholders but provides that shareholders other than corporations must include in computing their class A or class B capital gains their pro rata shares of the company's adjusted class A or adjusted class B capital gain (distributed and undistributed) in the appropriate taxable year.

Paragraph (11)(F) of section 219(c) of the bill amends section 1247(i) of the code. Section 1247(i) presently provides that if a qualified shareholder of a foreign investment company treats any amount designated under section 1247(a)(1)(B) with respect to a share of stock as long-term capital gain, and such share is held for less than 6 months, any loss on a sale or exchange of such share is, to the extent of such gain, treated as a long-term capital loss. Section 1247(i) as amended by this paragraph of the bill retains the present rule for corporate shareholders. In addition, it provides that if a shareholder other than a corporation treats any amounts designated under

section 1247(a)(1)(B) with respect to a share of stock in a foreign investment company as (1) class B capital gain, and such share is held for 6 months or less, then any loss on the sale or exchange of such share is, to the extent of such class B capital gain, treated as a loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years, or (2) class A capital gain, and such share is held by the taxpayer for 2 years or less, then any loss on the sale or exchange of such share is, to the extent of such class A capital gain, treated as a loss from the sale or exchange of a capital asset held for more than 2 years. If such shareholder treats the amounts designated under section 1247(a)(1)(B) with respect to such share as both class A and class B capital gains and such share is held for 6 months or less, and there is a loss from the sale or exchange of such share which is less than the sum of the amount so designated, then there is treated as loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years an amount of the loss from the sale or exchange of such share which bears the same relation to such loss as the class B capital gain so designated bears to the sum of such class A and class B capital gains so designated; and the remainder of such loss is treated as a loss from the sale or exchange of a capital asset held for more than 2 years.

(*d*) *Effective date.*—Subsection (d) of section 219 of the bill provides various rules concerning the effective date of the amendments made by section 219.

General rule

Paragraph (1) of section 219(d) of the bill provides that except as otherwise specifically provided, and except as provided by paragraph (2), the amendments made by section 219 are applicable to taxable years beginning after December 31, 1963.

Transition rules

Paragraph (2) of section 219(d) of the bill provides various transition rules relating to certain amounts which receive capital gain treatment.

Subparagraph (A)(i) of section 219(d)(2) of the bill provides that if a taxpayer, other than a corporation, is required to include as capital gain in his gross income for a taxable year beginning after December 31, 1963, an amount attributable to sales or exchanges of capital assets held for more than 6 months and such gain was realized in a taxable year beginning before January 1, 1964, by a person described in subparagraph (A)(iii), such amount is to be treated by such taxpayer as class B capital gain.

The foregoing is illustrated by the following example:

Example.—W, a shareholder (other than a corporation) of Z, a regulated investment company, is a calendar-year taxpayer. Z has a taxable year beginning March 1. In February 1964, Z distributes to W a capital gain dividend (as defined in existing sec. 852(b)(3)(C) of the code) of $90. W, since he received such dividend in a taxable year beginning after December 31, 1963, is to include $90 in his gross income as a class B capital gain.

Subparagraph (A)(ii) of section 219(d)(2) of the bill provides that if a taxpayer, other than a corporation, is required to include as capital gain in his gross income for a taxable year beginning before

January 1, 1964, an amount attributable to sales or exchanges of capital assets held for more than 6 months and such gain was realized in a taxable year beginning after December 31, 1963, by a person described in subparagraph (A)(iii), such amount is to be treated by such taxpayer as long-term capital gain.

The foregoing is illustrated by the following example:

Example.—X, a shareholder (other than a corporation) of Y, a regulated investment company, has a taxable year beginning December 1. Y is a calendar-year taxpayer. In November 1964, Y distributes a capital gain dividend (as defined in sec. 852(b)(3)(C) of the code, as amended by the bill) to its shareholders. With respect to such dividend, X receives from Y a notice properly designating $60 as class A capital gain and $30 as class B capital gain. Regardless of such designation, X, since he received such dividend in a taxable year beginning before January 1, 1964, is to treat $90 as a long-term capital gain.

Subparagraph (A)(iii) of section 219(d)(2) of the bill provides that the provisions of subparagraphs (A)(i) and (A)(ii) apply in respect of a regulated investment company or a real estate investment trust to which subchapter M of chapter 1 of the code applies, a foreign investment company to which section 1247 of the code applies, an electing small business corporation to which subchapter S of chapter 1 of the code applies, a common trust fund to which section 584 of the code applies, a partnership, an estate, and a trust.

Subparagraph (B) of section 219(d)(2) of the bill provides a transition rule in the case of loss on the sale or exchange of certain stock. This rule provides that if a shareholder (or a holder of a beneficial interest), other than a corporation, in a regulated investment company, real estate investment trust, or foreign investment company is required for a taxable year beginning before January 1, 1964, under section 852(b)(3) (B) or (D), section 857(b)(3)(B), or section 1247(d) of the code to treat an amount with respect to a share (or beneficial interest) as a long-term capital gain, and such share (or beneficial interest) is held by the taxpayer for less than 31 days (6 months or less in the case of a shareholder of a foreign investment company), then a loss on the sale or exchange of such share in a taxable year of such shareholder beginning after December 31, 1963, is to the extent of such long-term capital gain to be treated as loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years.

The foregoing is illustrated by the following example:

Example.—On December 12, 1963, T, a calendar-year taxpayer (other than a corporation), purchases shares of V, a regulated investment company. On December 20, 1963, T receives a $100 dividend from V which is properly designated as a capital gain dividend. On January 3, 1964, T sells all such shares in V and incurs a loss of $80. Such loss is treated as class B capital loss.

Regulatory authority

Subparagraph (C) of section 219(d)(2) of the bill provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as may be necessary to carry out the purposes of section 219(d).

Meaning of terms

Subparagraph (D) of section 219(d)(2) of the bill provides that terms used in section 219(d) have the same meaning as when used in chapter 1 of the code.

SECTION 220. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

(*a*) *Gain from dispositions of certain depreciable realty.*—Subsection (a) of section 220 of the bill adds to part IV of subchapter P of chapter 1 of the code (relating to special rules for determining capital gains and losses) a new section 1250. In general, the new section 1250 provides for the inclusion in gross income (as ordinary income) of the "applicable percentage" of the lower of (1) the gain from the disposition of certain depreciable realty, or (2) "additional depreciation" adjustments for periods after December 31, 1963, which are reflected in the adjusted basis of such realty.

SECTION 1250. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

(*a*) *General rule.*—Paragraph (1) of section 1250(a) provides the general rule that if "section 1250 property" is disposed of after December 31, 1963, the "applicable percentage" of the lower of (A) the "additional depreciation" in respect of the property, or (B) the excess of the amount realized (or the fair market value of such property in transactions in which no amount is realized) over the adjusted basis of the property, is treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 of the code. The term "disposed of," which has the same meaning as when used in section 1245(a)(1) of the code, includes any transfer or involuntary conversion.

Paragraph (2) of section 1250(a) defines the term "applicable percentage" for these purposes as 100 percent minus 1 percentage point for each full month the property involved was held after the date on which the property had been held 20 full months. For purposes of determining the applicable percentage, the holding period of section 1250 property is determined under the rules of section 1250 (e) and (f), and not under the rules of section 1223 of the code. In the case of section 1250 property held 20 months or less, the applicable percentage is 100 percent and, in the case of property held more than 20 months, the applicable percentage is 100 percent minus 1 percentage point for each full month (not in excess of 100 months) the property was held after the date on which the property had been held 20 full months. For example, the applicable percentage for property purchased on January 17, 1962, would be 100 percent on October 16, 1963; 99 percent on October 17, 1963; 1 percent on December 17, 1971; 1 percent on January 16, 1972; and zero percent on and after January 17, 1972. Thus, upon a disposition of property held at least 10 years, the applicable percentage is zero and no gain is treated as ordinary income under section 1250.

Paragraph (1) of section 1250(a) further provides (as does sec. 1245(a)(1) in cases to which it applies) that gain is to be recognized notwithstanding any other provision of subtitle A of the code. Thus,

other nonrecognition sections of the code are overridden by the new section. For example, gain under section 1250(a)(1) would be recognized to a corporation in the case of a distribution of section 1250 property by it to a shareholder, notwithstanding the provisions of section 311(a) or 336 of the code. Likewise, gain under section 1250(a)(1) would be recognized to a corporation on a sale or exchange of such property, nothwithstanding the provisions of section 337 of the code. The operation of section 1250 may, however, be affected by the taxpayer's method of accounting. For example, the gain from a disposition to which section 1250 applies may be reported by the taxpayer under the installment method if such method is otherwise available under section 453 of the code. For another example, section 1250 does not require recognition of gain or loss upon normal retirement of an asset in a multiple asset account as long as the taxpayer's method of accounting, in accordance with Treasury regulations, does not require recognition of such gain or loss and clearly reflects income.

In the case of a disposition of section 1250 property by a sale, exchange, or involuntary conversion, the gain to which section 1250(a)(1) applies is the applicable percentage for the property multiplied by the lower of the additional depreciation in respect of the property or the excess of the amount realized over its adjusted basis. In the case of any other disposition, the gain to which section 1250(a)(1) applies is the applicable percentage multiplied by the lower of the additional depreciation or the excess of the fair market value of the property on the date of disposition over its adjusted basis.

The application of section 1250(a) is illustrated by the following examples:

Example (1).—Section 1250 property which has an adjusted basis of $2,000 is sold for $2,900. At the time of the sale the additional depreciation in respect of the property is $1,300 and the applicable percentage is 60 percent. Since the amount realized minus the adjusted basis of the property ($2,900 minus $2,000) is lower than the additional depreciation ($1,300), the amount of gain which is treated as ordinary income under section 1250(a)(1) is $540 (that is, 60 percent of $900).

Example (2).—Assume the same facts as in example (1) except that the property is distributed by a corporation to a stockholder in a distribution to which section 1250(a) applies and that at the time of the distribution the fair market value of the property is $3,700. Since the additional depreciation ($1,300) is lower than the fair market value minus the adjusted basis of the property ($3,700 minus $2,000), the amount of gain recognized and treated as ordinary income to the corporation under section 1250(a)(1) is $780 (that is, 60 percent of $1,300).

(*b*) *Additional depreciation defined.*—The term "additional depreciation" is defined in section 1250(b).

In general

Paragraph (1) of section 1250(b) provides that the term "additional depreciation" means, in the case of property which at the time of disposition has been held for not more than 1 year, the depreciation adjustments in respect of such property. The term "depreciation adjustments," which is limited to adjustments attributable to periods after December 31, 1963, is defined in section 1250(b)(3).

In the case of property which at the time of disposition has been held for more than 1 year, the term "additional depreciation" means depreciation in excess of straight line depreciation—that is, the excess (if any) of the sum of the depreciation adjustments in respect of the property (attributable to periods after December 31, 1963) over the sum of the depreciation adjustments which would have resulted (for periods after December 31, 1963) if such adjustments had been determined, for the entire period the property was held, under the straight line method of depreciation. However, "additional depreciation" for periods after December 31, 1963, is reduced by the excess (if any) of the sum of the depreciation adjustments which would have resulted under the straight line method attributable to periods before January 1, 1964, over the sum of the actual depreciation adjustments attributable to periods before such date.

Depreciation in excess of straight line depreciation may arise, for example, if the declining balance method, the sum of the years-digits method, or the units of production method is used, or for another example, if the cost of a leasehold improvement or of a leasehold is depreciated over a period which does not take into account certain renewal periods referred to in section 1250(b)(2).

For purposes of paragraph (1) of section 1250(b), if a useful life (or salvage value) was used in determining the amount allowed as a depreciation adjustment for any taxable year, such life (or value) is used in determining the depreciation adjustments which would have resulted for such taxable year under the straight line method. However, if for any taxable year a method of depreciation was used as to which a useful life was not taken into account, such as, for example, the units of production method, or as to which salvage value was not so taken into account in determining the annual allowances, such as, for example, the declining balance method or the amortization of a leasehold improvement over the term of a lease, then, for the purpose of determining the depreciation adjustments which would have resulted under the straight line method for such taxable year, there is used the useful life or salvage value which would have been proper if depreciation had actually been determined under the straight line method. For this purpose, such useful life or such salvage value is determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method.

The application of section 1250(b)(1) is illustrated by the following examples:

Example (1).—On January 1, 1968, a calendar-year taxpayer sells section 1250 property which he purchased for $10,000 on January 1, 1961. Throughout the period he held the property he computed depreciation under the declining balance method using a rate of 200 percent of the straight line rate and a useful life of 30 years. Under such method, salvage value is not taken into account in computing the annual allowance. If the taxpayer had computed depreciation under the straight line method he would have used a salvage value of $1,000. The depreciation on the property under both methods is set forth below:

Year	Declining balance	Straight line
1961	$667	$300
1962	622	300
1963	581	300
1964	542	300
1965	506	300
1966	472	300
1967	440	300
Sum of depreciation deductions for periods after Dec. 31, 1963	$1,960	$1,200

The additional depreciation for the property is $760—that is, the depreciation actually deducted for periods after December 31, 1963 ($1,960), minus the depreciation which would have resulted for such periods under the straight line method ($1,200).

Example (2).—A calendar-year taxpayer sells section 1250 property on January 1, 1971, which he purchased for $10,000 on January 1, 1964. For the period 1964 through 1968 he computed depreciation deductions in respect of the property under the declining balance method using a rate of 200 percent of the straight line rate and a useful life of 10 years. If the taxpayer had used the straight line method for such period, he would have used a salvage value of $1,000. As of January 1, 1969, the taxpayer elected to change to the straight line method. He redetermined the remaining useful life of the property to be 8 years and its salvage value to be $77. The depreciation of the property under both methods is set forth below:

Year	Actual depreciation	Straight line
1964	$2,000	[1] $900
1965	1,600	900
1966	1,280	900
1967	1,024	900
1968	819	900
1969	[2] 400	[3] 678
1970	400	678
Sum of depreciation deductions	$7,523	$5,856

[1] 1/10 of $9,000 ($10,000 minus $1,000).
[2] 1/8 of $3,200 ($3,277 minus $77).
[3] 1/8 of $5,423 ($5,500 minus $77).

The additional depreciation for the property is $1,667—that is, the depreciation actually deducted ($7,523), minus the depreciation which would have resulted under the straight line method ($5,856).

Property held by lessee

Paragraph (2) of section 1250(b) provides that, in the case of a lessee, in determining the depreciation adjustments which would have resulted under the straight line method in respect of any building erected (or other improvement made) on the leased property, or in respect of any cost of acquiring the lease, the lease period is treated as including all renewal periods. The term "renewal period" is defined in paragraph (2)(A) as any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee. However, paragraph (2)(B) provides that the inclusion of renewal periods does not extend the period taken into account by more than

two-thirds of the period on the basis of which the depreciation adjustments were allowed. Thus, for example, if a leasehold improvement was amortized on the basis of a 10-year initial lease term, and if the lease was renewable for an additional 9 years, then the period taken into account is 16⅔ years, that is, 10 years plus two-thirds of 10 years. If, however, the useful life of the leasehold improvement were only 15 years, then the period taken into account would be 15 years.

Depreciation adjustments

Paragraph (3) of section 1250(b) provides that the term "depreciation adjustments" means, in respect of any property, all adjustments attributable to periods after December 31, 1963, reflected in the adjusted basis of such property on account of deductions for depreciation, whether in respect of the same or other property and whether allowed or allowable to the taxpayer or to any other person. The depreciation deductions referred to are deductions for exhaustion, wear and tear, obsolescence, or amortization (other than amortization of emergency facilities under sec. 168 of the code).

Adjustments reflected in adjusted basis, for purposes of section 1250(b)(3), generally do not include deductions for depreciation in respect of retired or demolished portions of a piece of section 1250 property unless such deductions are reflected in the basis of replacement property which is section 1250 property. Thus, for example, if a wing of a building is totally destroyed by fire, the depreciation adjustments reflected in the adjusted basis of the building after the wing is destroyed do not include any deductions for depreciation attributable to the destroyed wing (unless the wing is replaced in a transaction described in sec. 1033 of the code (relating to involuntary conversions) and the adjustments for depreciation in respect of the destroyed property are reflected in the basis of the replacement property).

While the amount of the depreciation adjustments is determined with respect to adjustments to basis for deductions which were either allowed or allowable, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any taxable year was less than the amount allowable, the amount taken into account for such taxable year will be the amount allowed. For example, assume that in the year 1969 it becomes necessary to determine the additional depreciation in respect of section 1250 property, the adjusted basis of which reflects a depreciation adjustment of $1,000 with respect to depreciation deductions allowable for the calendar year 1964 under the sum of the years-digits method. If the taxpayer can establish by adequate records or other sufficient evidence that he did not take, and was not allowed, any deduction for depreciation in respect of the property in 1964, then, for purposes of section 1250, in respect of the property, the amount of the depreciation adjustments (and, accordingly, the additional depreciation) attributable to 1964 will be zero.

The application of section 1250(b)(3) is illustrated by the following example:

Example.—A taxpayer purchases section 1250 property on January 1, 1964, at a cost of $10,000 and takes depreciation deductions of $2,000 (the amount allowable), of which $500 is additional depreciation. The taxpayer then transfers the property to his son as a gift. Immediately after the transfer the son's adjusted basis in the property for purposes of determining gain is, under the provisions of sections

1015 (relating to the basis of property acquired by gift) and 1016 (relating to adjustments to basis) of the code, the same as his father's adjusted basis ($8,000), and the $2,000 of depreciation deductions, of which $500 is additional depreciation, taken by the father is reflected in the son's adjusted basis in the property. Moreover, if the son himself takes, in respect of the property, depreciation deductions of $1,000 (the amount allowable), of which $200 is additional depreciation, the adjusted basis of the property would then reflect depreciation deductions of $3,000, of which $700 would be additional depreciation

(c) *Section 1250 property.*—Section 1250(c) defines "section 1250 property" as any real property (other than sec. 1245 property, as defined in sec. 1245(a)(3) of the code) which is or has been property of a character subject to the allowance for depreciation provided in section 167 of the code. Section 1250 property must be depreciable in the same sense that section 1245 property must be depreciable. Even though the property may not be subject to the allowance for depreciation in the hands of the taxpayer, such property is nevertheless subject to the provisions of section 1250(a)(1) if the property was subject to the allowance for depreciation in the hands of any prior holder, and if such depreciation is taken into account in determining the adjusted basis of the property in the hands of the taxpayer.

The term "section 1250 property" includes three types of depreciable real property. The term "real property" means any property which is not personal property within the meaning of section 1245 (a)(3)(A) of the code. The first type is intangible real property. For purposes of section 1250(c), a leasehold of land or of section 1250 property is intangible real property, and accordingly such a leasehold is section 1250 property. However, since land itself is not depreciable, a fee simple interest in land is not section 1250 property. The second type is a building or its structural components (within the meaning of sec. 1245(a)(3)(B)). The third type is all other tangible real property except property described in section 1245(a)(3)(B). An elevator or escalator (within the meaning of sec. 1245(a)(3)(C), as added by sec. 202(d)(3) of the bill) is not section 1250 property.

Property may lose its character as section 1250 property and become section 1245 property. Thus, for example, if section 1250 property of the third type is held for 3 years and thereafter is converted to use as an integral part of manufacturing, the property would lose its character as section 1250 property and would become section 1245 property. However, once property in the hands of a taxpayer is section 1245 property, it can never become section 1250 property in the hands of such taxpayer.

(d) *Exceptions and limitations.*—Section 1250(d) sets forth certain exceptions and limitations to the general rule provided in section 1250(a)(1). Paragraphs (1), (2), and (3) of section 1250(d) are identical to paragraphs (1), (2), and (3) of section 1245(b), and paragraphs (4), (5), and (6) of section 1250(d) correspond to paragraphs (4), (5), and (6) of section 1245(b). Paragraph (7) of section 1250(d) has no counterpart in section 1245(b).

Gifts

Paragraph (1) of section 1250(d) provides that section 1250(a) will not apply to a disposition by gift.

Transfers at death

Paragraph (2) of section 1250(d) provides that, except as provided in section 691 of the code, section 1250(a) will not apply to a transfer at death.

Certain tax-free transactions

Paragraph (3) of section 1250(d) provides that if the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of certain sections of the code providing for nonrecognition treatment, then the amount of gain taken into account by the transferor under section 1250(a)(1) is limited to the amount of gain recognized by the transferor under these sections (determined without regard to sec. 1250). These nonrecognition provisions are: Section 332 (relating to distributions in liquidation of an 80 percent or more controlled subsidiary corporation); section 351 (relating to transfers to a corporation controlled by the transferor); section 361 (relating to exchanges pursuant to certain corporate reorganizations); section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings); section 374(a) (relating to exchanges pursuant to certain railroad reorganizations); section 721 (relating to transfers to a partnership in exchange for a partnership interest); and section 731 (relating to distributions by a partnership to a partner).

Since the limitation provided in section 1250(d)(3) upon the gain recognized under section 1250(a) is confined to instances of "carryover basis," in the case of the liquidation of an 80-percent-or-more-controlled subsidiary the limitation is not applicable if the basis of the property in the hands of the parent corporation is determined under section 334(b)(2) of the code. Section 1250(d)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) exempt from taxation under chapter 1 of the code, but no implication is intended as to whether a transfer to such an exempt organization could or could not qualify for nonrecognition under the sections of the code set forth in section 1250(d)(3).

The application of section 1250(d)(3) is illustrated by the following example:

Example.—A taxpayer transfers section 1250 property to a corporation, which is not exempt from taxation, in exchange for cash of $1,000 and stock in the corporation worth $9,000, in a transaction qualifying under section 351 of the code. The property has a fair market value of $10,000 and an adjusted basis of $4,000. In respect of the property, the additional depreciation is $2,000 and the applicable percentage is 60 percent. Since the additional depreciation ($2,000) is lower than the fair market value of the property minus its adjusted basis ($10,000 minus $4,000), the amount of gain which would be treated as ordinary income under section 1250(a)(1) would be $1,200 (60 percent of $2,000) if the provisions of section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $1,000 would be recognized to the transferor without regard to the new section 1250, section 1250 (d)(3) limits the gain taken into account by the transferor under section 1250(a)(1) to $1,000.

Like kind exchanges; involuntary conversions, etc.

Paragraphs (4) (A), (B), and (C) of section 1250(d) provide that if section 1250 property is disposed of and gain (determined without regard to sec. 1250) is not recognized in whole or in part under section

1031 (relating to like kind exchanges) or 1033 (relating to involuntary conversions) of the code, then the amount of gain taken into account by the transferor under section 1250(a)(1) cannot in effect exceed the greater of two limitations. The first limitation is the sum of—

(A) the amount of gain recognized on the disposition under section 1031 or 1033 (determined without regard to sec. 1250), plus

(B) the amount specified in paragraph (4)(B) of section 1250(d)—that is, an amount equal to the fair market value of any stock purchased in a corporation which (but for sec. 1250(d)(4)) would result in nonrecognition of gain under section 1033(a)(3)(A).

The second limitation is the amount specified in paragraph (4)(C) of section 1250(d)—that is, the amount (if any) by which—

(i) the amount of gain which would (but for sec. 1250(d)(4)) be taken into account under section 1250(a)(1), exceeds

(ii) the fair market value (or cost in the case of a transaction described in sec. 1033(a)(3)) of the section 1250 property acquired in the transaction.

The application of section 1250(d)(4) (A), (B), and (C) is illustrated by the following example:

Example.—A taxpayer receives $116,000 in insurance proceeds upon the destruction of section 1250 property by fire. If section 1250(d)(4) did not apply to the disposition, $20,000 of gain would be recognized under section 1250(a)(1). In acquisitions qualifying under section 1033(a)(3)(A) of the code, he uses $110,000 of the proceeds to purchase property similar or related in service or use to the property destroyed, of which $15,000 is for section 1250 property and $95,000 is for land, and $5,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the property destroyed. The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain (determined without regard to sec. 1250) to $1,000—that is, the amount by which the amount realized from the conversion ($116,000) exceeds the cost of the property acquired in acquisitions qualifying under section 1033(a)(3)(A) ($115,000, that is $110,000 plus $5,000). The amount of gain recognized under section 1250(a)(1) is $6,000, determined in the following manner:

The first limitation:	
(A) Amount of gain recognized under sec. 1033(a)(3)(A), determined without regard to sec. 1250(a)(1)	$1, 000
(B) Fair market value of stock in a corporation which qualifies under sec. 1033(a)(3)(A)	5, 000
Sum of (A) plus (B)	$6, 000
The second limitation:	
(i) Amount of gain which would be recognized under sec. 1250(a)(1) if sec. 1250(d)(4) did not apply	$20, 000
(ii) Cost of sec. 1250 property acquired in transaction	15, 000
Excess of (i) over (ii)	$5, 000

NOTE.—Since the first limitation ($6,000) exceeds the second limitation ($5,000), the amount of gain recognized under sec. 1250(a)(1) is $6,000.

Paragraph (4)(D) of section 1250(d) provides rules for reducing the basis of section 1250 property acquired in a like kind exchange or involuntary conversion in case gain is not recognized under section 1250(a)(1) by reason of the application of section 1250(d)(4). The first sentence of such paragraph (4)(D) states a special rule for applying the last sentence of section 1033(c) of the code (relating to involuntary conversion into money). The last sentence of section 1033(c) provides:

> In the case of property purchased by the taxpayer in a transaction described in subsection (a)(3) [of sec. 1033] which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

Under clause (i) of section 1250(d)(4)(D), the last sentence of section 1033(c) is first applied to determine a basis for the section 1250 properties purchased equal to the cost of such properties less the amount of gain not taken into account under section 1250(a)(1) by reason of the application of section 1250(d)(4); if more than one piece of section 1250 property is so purchased, such basis is allocated to each of the properties in proportion to their respective costs.

Clause (ii) of section 1250(d)(4)(D) applies in case the purchased properties which qualify under section 1033(a)(3) include not only section 1250 property but other property as well. In such a case the last sentence of section 1033(c) is applied to all such purchased properties in the following manner: First the basis determined under clause (i) (cost less unrecognized sec. 1250 gain) for the section 1250 properties purchased is treated as if it were the cost thereof. Then there is determined a basis for all the purchased properties equal to the cost of such properties less the excess of the amount of gain not taken into account by reason of the application of section 1033(a)(3)(A) over the amount of gain not taken into account under section 1250(a)(1) by reason of the application of section 1250(d)(4). Finally, such basis is allocated to each of such purchased properties in proportion to their respective costs.

The last sentence of section 1250(d)(4)(D) provides that in the case of a transaction not described in the preceding provisions thereof in which an amount was not recognized as gain under section 1250(a)(1) by reason of the application of section 1250(d)(4), rules consistent with such preceding provisions shall be applied under regulations prescribed by the Secretary of the Treasury or his delegate.

The application of section 1250(d)(4)(D) is illustrated by the following example:

Example.—A taxpayer owns section 1250 property B which is destroyed by fire and insurance proceeds of $90,000 are received. In acquisitions qualifying under section 1033(a)(3)(A) of the code, he uses all of the proceeds to purchase property similar or related in service or use to the property destroyed, of which $42,000 is for 2 pieces of section 1250 property ($10,500 for C, and $31,500 for D), and $48,000

is for 2 pieces of land ($12,000 for X, and $36,000 for Y). No gain is recognized upon the involuntary conversion. Assume that the gain not recognized under section 1033(a)(3)(A) is $60,000, of which gain of $10,000 is not recognized under section 1250(a)(1) by reason of the application of section 1250(d)(4). Under the last sentence of section 1033(c) and under clause (i) of section 1250(d)(4)(D), the tentative total basis of the section 1250 properties purchased is $32,000, that is, the cost of the properties ($42,000), minus the gain not recognized by reason of section 1250(d)(4) ($10,000). The tentative basis of C is $8,000 $\left(\$32{,}000 \times \frac{\$10{,}500}{\$42{,}000}\right)$ and the tentative basis of D is $24,000 $\left(\$32{,}000 \times \frac{\$31{,}500}{\$42{,}000}\right)$.

Under clause (ii) of section 1250(d)(4)(D) and the last sentence of section 1033(c), the basis of all the purchased properties is determined in the following manner:

Cost (tentative basis) of sec. 1250 property C		$8, 000
Cost (tentative basis) of sec. 1250 property D		24, 000
Cost of parcel of land X		12, 000
Cost of parcel of land Y		36, 000
Cost of properties purchased		80, 000
Less: Gain not recognized by reason of sec. 1033(a)(3)(A)	$60, 000	
Minus gain not recognized by reason of sec. 1250(d)(4)	10, 000	
		50, 000
Total basis of properties purchased		$30, 000

The total basis of $30,000 is allocated to each property in the following manner:

Property		Basis
C	$30,000 × ($8,000/$80,000)	$3, 000
D	$30,000 × ($24,000/$80,000)	9, 000
X	$30,000 × ($12,000/$80,000)	4, 500
Y	$30,000 × ($36,000/$80,000)	13, 500
Total		$30, 000

Paragraph (4)(E) of section 1250(d) provides that the amount of any gain which was not recognized under section 1250(a)(1), by reason of the application of section 1250(d)(4) upon a like kind exchange or involuntary conversion, is carried over to the section 1250 property acquired in such transaction as the amount of the additional depreciation attributable to the section 1250 property disposed of. A new holding period of such property begins under section 1250(e)(1) and the amount of the section 1250(a)(1) gain not recognized upon the like kind exchange or involuntary conversion may be recognized upon a subsequent disposition of the property acquired in such a transaction, but only to the extent of such gain multiplied by the applicable percentage for the acquired property.

The application of section 1250(d)(4)(E) is illustrated by the following example:

Example.—Section 1250 property X is condemned and all of the proceeds are used to purchase section 1250 property Y in a transaction qualifying under section 1033(a)(3)(A) of the code. The amount

of gain not recognized under section 1250(a)(1) by reason of the application of section 1250(d)(4) is $10,000. Purchased section 1250 property Y, after being held for 50 full months, is sold for $35,000, and at the time of the sale the adjusted basis of Y is $5,000 and the additional depreciation in respect of Y for periods after it was acquired is $2,500. Accordingly, the additional depreciation in respect of Y is $12,500—that is, the sum of the amount of gain which was not recognized under section 1250(a)(1) by reason of the application of section 1250(d)(4) upon the disposition of X ($10,000), plus the additional depreciation in respect of Y for periods after it was acquired ($2,500). Since the additional depreciation in respect of Y ($12,500) is lower than the excess of the amount realized over the adjusted basis of Y ($30,000—that is, $35,000 minus $5,000), the amount treated as ordinary income under section 1250(a)(1) upon the sale of Y is $8,750 (that is, 70 percent of $12,500). If, however, Y were sold for only $14,000, the excess of the amount realized over the adjusted basis of Y ($9,000—that is, $14,000 minus $5,000) would be lower than the additional depreciation ($12,500) and, accordingly, the amount treated as ordinary income under section 1250(a)(1) would be $6,300 (that is, 70 percent of $9,000).

Section 1071 and 1081 transactions

Paragraph (5) of section 1250(d) provides that the Secretary of the Treasury or his delegate is to prescribe regulations setting forth rules consistent with paragraphs (3) and (4) of section 1250(d) and with sections 1250 (e) and (f) in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC) of the code.

Property distributed by a partnership to a partner

Paragraph (6)(A) of section 1250(d) provides that, for purposes of section 1250, the basis of section 1250 property distributed by a partnership to a partner is deemed to be determined by reference to the adjusted basis of such property to the partnership. Paragraph (6)(B) provides in general that, after a distribution to which section 751(b) of the code did not apply, the additional depreciation attributable to periods before the distribution of such property is an amount equal to the gain referred to in clause (i) of paragraph (6)(B)—that is, the amount of gain to which section 1250(a)(1) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time and the applicable percentage for the property had been 100 percent. If, however, section 751(b) applied to any part of the gain actually recognized under section 1250(a)(1), then after the distribution the additional depreciation attributable to periods before the distribution would be an amount equal to the gain referred to in clause (i) minus an amount (referred to in clause (ii) of paragraph (6)(B)) equal to the gain actually recognized under section 1250(a)(1) to which section 751(b) applied, such gain to be recomputed as if the applicable percentage for the property had been 100 percent. Thus, for example, if a partnership distributes section 1250 property to a partner at a time when the applicable percentage for the property is 60 percent, and

as a result of the distribution the amount of gain recognized to the partnership under section 1250(a)(1) and to which section 751(b) applied was $600 (that is, 60 percent of $1,000), then the amount referred to in clause (ii) of paragraph (6)(B) is $1,000 (that is, 100 percent of $1,000).

The application of section 1250(d)(6) is illustrated by the following example:

Example.—Asset X, which is section 1250 property held by partnership ABC, has an adjusted basis of $5,000 and a fair market value of $6,000. In respect of the property the additional depreciation is $2,000 and the applicable percentage is 75 percent. The property is distributed to B in complete liquidation of his partnership interest in a transaction to which section 751(b) of the code does not apply. If immediately before the distribution the partnership had sold the property at its fair market value at such time and if the applicable percentage were 100 percent, the gain to which section 1250(a)(1) applied would be $1,000—that is, 100 percent of the lower of the additional depreciation ($2,000) or the excess of fair market value over adjusted basis ($6,000 minus $5,000). Accordingly, under section 1250(6)(B), immediately after the distribution the additional depreciation in respect of the property is $1,000. Assuming that B's basis for his partnership interest is $4,000, under section 732 of the code this basis is allocated to the property. If B sells the property for $6,000 immediately after the distribution, then the gain to which section 1250(a)(1) applies is $750—that is, 75 percent of the lower of the additional depreciation ($1,000) or the excess of the amount realized over adjusted basis ($6,000 minus $4,000).

Principal residence

Paragraph (7)(A) of section 1250(d) provides that section 1250(a)(1) does not apply to a disposition of property by a taxpayer to the extent the property is used by the taxpayer as his principal residence. For purposes of paragraph (7)(A), the term "principal residence" has the meaning which such term has in section 1034(a) of the code (relating to sale or exchange of residence). Thus, for example, if a doctor sells his principal residence, a portion of which had properly been subject to the allowance for depreciation as property used in his trade or business, section 1250(a)(1) applies only in respect of the disposition of such portion of the residence. Moreover, even if section 1034 did not apply to the sale because, for example, the doctor did not invest in a new principal residence within the period specified in section 1034, section 1250(a)(1) would apply only to the disposition of such portion of the residence.

Paragraph (7)(B) of section 1250(d) provides that section 1250(a)(1) does not apply to a disposition of section 1250 property by a taxpayer who, in respect of the property, meets the age and ownership requirements of section 121 of the code (relating to exclusion from gross income of gain on sale or exchange of residence of individual who has attained age 65, added by sec. 206 of the bill), but only to the extent the taxpayer meets the use requirements of section 121 in respect of such property. Thus, if a taxpayer has attained the age of 65 before the date on which he disposes of section 1250 property, and if during the 8-year period ending on the date of the disposition the property has been owned and used by the taxpayer solely as his principal resi-

dence for periods aggregating 5 years or more, then section 1250(a)(1) does not apply in respect of the disposition. This result would not be changed even if the taxpayer does not or cannot make the election provided for in section 121 and even if section 121 applies to only a portion of the gain because the adjusted sales price exceeds the $20,000 limitation in section 121(b)(1). If, however, only a portion of the property has been used as his principal residence for such periods aggregating 5 years or more, then section 1250(a)(1) applies to the portion not so used.

In the case of certain dispositions described in section 1250(d)(7), the amount of the depreciation adjustments and the amount of the additional depreciation is carried over to the property in the hands of the transferee—for example, where the disposition is a gift referred to in section 1250(d)(1). For the donee's holding period, see section 1250(e)(2). If section 1034 of the code applies to a disposition by a taxpayer described in section 1250(d)(7), such amounts will be carried over to the new principal residence of the taxpayer.

(*e*) *Holding period.*—Section 1250(e) provides that, for purposes only of determining the applicable percentage (as defined in sec. 1250(a)(2)) of section 1250 property, the holding period of the property is determined under the rules of section 1250(e) and not under the rules of section 1223 of the code. Section 1250(e) does not affect the determination of the amount of depreciation adjustments, or of additional depreciation, in respect of section 1250 property, and conversely the holding period determined under section 1250(e) is not affected if a depreciation adjustment was disallowed because, for example, the depreciation adjustment would have reduced the adjusted basis of the property below the amount realized on the disposition.

Beginning of holding period

Paragraph (1) of section 1250(e) states when the holding period of section 1250 property begins for the purpose of determining the applicable percentage in respect of the property.

Subparagraph (A) of section 1250(e)(1) provides that in the case of property acquired (other than in a transaction referred to in par. (2) or (3) of sec. 1250(e)) by a taxpayer, the holding period of the property in the hands of the taxpayer begins on the day after the date of the acquisition. Thus, for example, if a taxpayer purchases section 1250 property on January 1, 1965, the holding period of the property begins on January 2, 1965. If the taxpayer sells the property on September 1, 1966, the holding period of the property on the day of the sale is exactly 20 full months. This result would not be changed even if the property initially had been used solely as the taxpayer's residence for a portion of the 20-month period.

Subparagraph (B) of section 1250(e)(1) provides that in the case of property constructed, reconstructed, or erected by a taxpayer, the holding period of the property in the hands of the taxpayer begins on the first day of the month during which the property is placed in service. Thus, for example, if a taxpayer constructs section 1250 property and places it in service on January 15, 1965, the holding period of the property begins on January 1, 1965. If the taxpayer sells the property on December 31, 1966, the holding period of the property on the day of sale is exactly 24 months. For purposes of subparagraph (B), property is placed in service on the date on which

the property is first used, whether in a trade or business, in the production of income, or in a personal activity. Thus, for example, a residence constructed by a taxpayer for his personal use is placed in service on the date it is occupied as a residence. For purposes of determining the date property is placed in service, it is immaterial when the period begins for depreciation with respect to the property under any depreciation practice which begins depreciation in any month other than the month in which the property is placed in service. If two or more units of one new property are placed in service on different dates before the completion of the property, or if, after completion of the property, one or more improvements are made to the property, the holding period of the property is determined in accordance with the special rules for property which is substantially improved provided in section 1250(f).

Property with transferred basis

Paragraph (2) of section 1250(e) provides that if the basis of property acquired in a transaction described in certain paragraphs of section 1250(d) is determined by reference to its basis in the hands of the transferor, then the holding period of the property in the hands of the transferee includes the holding period of the property in the hands of the transferor. These paragraphs of section 1250(d) are: Paragraph (1) (relating to gifts); paragraph (2) (relating to transfers at death); paragraph (3) (relating to certain tax-free transactions); and paragraph (5) (relating to sec. 1071 and 1081 transactions). If, however, the adjusted basis of the property in the hands of the transferee immediately after a transaction to which section 1250(e)(2) otherwise applies exceeds its adjusted basis in the hands of the transferor immediately before the transaction, the holding period of the property is determined in accordance with the special rules for property which is substantially improved provided in section 1250(f).

Principal residence

Paragraph (3) of section 1250(e) provides that if the basis of property acquired in a transaction described in section 1250(d)(7) (relating to disposition of principal residence) is determined by reference to the basis in the hands of the taxpayer of other property, then the holding period of the property acquired includes the holding period of such other property. If, however, the adjusted basis of property acquired in a transaction to which section 1250(e)(3) otherwise applies exceeds the adjusted basis of the property disposed of, the holding period of the property acquired is determined in accordance with the special rules for property which is substantially improved provided in section 1250(f).

(*f*) *Special rules for property which is substantially improved.*—Section 1250(f) provides rules for determining the amount of gain to be taken into account as ordinary income under section 1250(a)(1) in the case of a disposition of property which, by reason of the application of section 1250(f)(3), consists of two or more "elements" with separate holding periods.

Amount treated as ordinary income

Paragraph (1) of section 1250(f) provides that, if section 1250 property consisting of more than one element is disposed of, the amount of gain taken into account under section 1250(a)(1) in respect

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of the property as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 of the code is the sum of the amounts of gain determined separately for each element in accordance with section 1250(f)(2).

Paragraph (2) of section 1250(f) provides, for purposes of section 1250(f)(1), the manner of determining separately the amount of gain for an element. The determination is made in three steps. The first step is to ascertain in respect of the property as a whole the lower of the additional depreciation in respect of the property (as defined in sec. 1250(b)) or the gain referred to in section 1250(a)(1)(B) (that is, the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion of the property), or the fair market value of the property (in the case of any other disposition) over the adjusted basis of the property). The second step is to determine with respect to the element, as if it were a separate property, the additional depreciation for the element and the applicable percentage (as defined in sec. 1250(a)(2)) for the element. The final step is to determine the amount of gain to be taken into account for the element by multiplying—

(A) an amount which bears the same ratio to the lower of the additional depreciation in respect of the whole property or the gain referred to in section 1250(a)(1)(B) as the additional depreciation for the element bears to the sum of the additional depreciation for all the elements, by

(B) the applicable percentage for the element.

The application of section 1250(f) (1) and (2) is illustrated by the following example:

Example.—Assume that section 1250 property is sold for $60,000 at a time when it has an adjusted basis of $25,000 and the additional depreciation for the property is $20,000. Thus, in respect of the property as a whole, the additional depreciation ($20,000) is lower than the gain referred to in section 1250(a)(1)(B) ($60,000 minus $25,000). Assume further that, by reason of the application of section 1250(f)(3), the property consists of four elements (W, X, Y, and Z), and that the additional depreciation and applicable percentage for each element, determined as if each element were a separate property, are as follows:

Element	Additional depreciation	Applicable percentage
W	$12,000	0
X	6,000	50
Y	0	63
Z	6,000	75
Total	$24,000	

(With respect to element Y, additional depreciation is zero because depreciation allowed was $4,000 less than straight line and, accordingly, the sum of the additional depreciation for each element is $4,000 greater than the additional depreciation in respect of the property as a whole.) For purposes of section 1250(f)(1), the amount

of gain taken into account under section 1250(a)(1) for each element is determined as follows:

W	$\frac{\$12,000}{\$24,000} \times \$20,000 \times 0$ percent	0
X	$\frac{\$6,000}{\$24,000} \times \$20,000 \times 50$ percent	\$2,500
Y	$\frac{\$0}{\$24,000} \times \$20,000 \times 63$ percent	0
Z	$\frac{\$6,000}{\$24,000} \times \$20,000 \times 75$ percent	3,750
	Total	\$6,250

Thus, upon sale of the property, the amount of gain taken into account under section 1250(a)(1) is $6,250.

Property consisting of more than one element

Paragraph (3)(A) of section 1250(f) provides that, for purposes of applying section 1250(f) in the case of section 1250 property, each "separate improvement" (as defined in par. (4) of sec. 1250(f)) to the property is treated as a separate element. Thus, for example, if before January 1, 1966, no portion of a 5-year-old building of six floors is a separate element, and if on such date there is added to the building two new floors which are one separate improvement (within the meaning of par. (4)(A)), then the building consists of two separate elements; the two new floors are one element and the residue of the building is the second element.

Paragraph (3)(B) of section 1250(f) provides that if, prior to completion of section 1250 property, units thereof (as distinguished from improvements) were placed in service, each such unit of the section 1250 property is treated as a separate element. Thus, for example, if a taxpayer who constructs an apartment house consisting of 100 identical apartments places in service 30 apartments on January 1, 1965, 50 on July 15, 1965, and 20 on January 19, 1966, and if the taxpayer disposes of the apartment house on January 1, 1969, then on such date the apartment house consists of 3 elements, and, accordingly, 30 percent of the apartment house, which has a holding period of 48 full months, has an applicable percentage of 72 percent; 50 percent of the apartment house, which has a holding period of 42 full months, has an applicable percentage of 78 percent; and 20 percent of the apartment house, which has a holding period of 36 full months, has an applicable percentage of 84 percent. Moreover, if there were also one or more separate improvements on the apartment house, each such separate improvement would also be a separate element.

Paragraph (3)(C) of section 1250(f) provides that the remaining property which is not taken into account under paragraph (3) (A) or (B) of such section is also treated as a separate element.

Property which is substantially improved

Paragraph (4)(A) of section 1250(f) defines the term "separate improvement" for the purpose of determining when an improvement (within the meaning of par. (4) (B) and (C)) is an element. The term "separate improvement" means, in respect of any section 1250 property, each improvement added during the 36-month period ending on the last day of any taxable year to the capital account for the property, but only if the sum of the amounts added as improvements to such account during such 36-month period exceeds the greatest of the amounts specified in clauses (i), (ii), and (iii) of paragraph (4)(A), that is—

(i) 25 percent of the adjusted basis of the property,

(ii) 10 percent of the adjusted basis of the property, determined without regard to the adjustments provided in section 1016(a) (2) and (3) (that is, generally, 10 percent of the cost or unadjusted basis of the property), or

(iii) $5,000.

The basis described in clause (ii) (hereinafter referred to as "unadjusted basis") is, in effect, the adjusted basis of the property recomputed by adding back the depreciation adjustments referred to in section 1250(b)(3) (without regard to the last sentence thereof) and adjustments for amortization under section 168 of the code, without regard to whether such depreciation or amortization adjustments were for periods before January 1, 1964, or were allowed or allowable to another taxpayer or in respect of other property.

Paragraph (4)(A) of section 1250(f) further provides that, for purposes of clauses (i) and (ii) thereof, the adjusted basis or unadjusted basis of section 1250 property is determined as of the beginning of the first day of the 36-month period, or the first day of the holding period of the property (within the meaning of sec. 1250(e)), whichever is the later. For purposes of clause (i) (or clause (ii)), the adjusted basis (or unadjusted basis) of section 1250 property includes the depreciated cost (or the cost) of any improvements to the property (including improvements which are not taken into account for purposes of par. (4)(A) because of the application of par. (4)(B)). However, such adjusted basis (or unadjusted basis) does not include the cost of retired components which are no longer a portion of the section 1250 property unless the adjusted basis of such retired portions is reflected in the basis of the replacement property.

Paragraph (4)(B) of section 1250(f), an exception to the definition of separate improvement, provides that improvements to section 1250 property in any taxable year are taken into account for purposes of paragraph (4)(A) only if the sum of the amounts added to the capital account for the property during such taxable year exceeds the greater of—

(i) $2,000, or

(ii) 1 percent of the unadjusted basis of the property, determined as of the first day of such taxable year.

Thus, for example, if the unadjusted basis of section 1250 property on January 1, 1960, is $300,000, and if the only improvements added to the property during the taxable year ending on December 31, 1960, are improvement A, costing $1,000, and improvement B, costing $600, the sum of the cost of improvements added during such

taxable year is less than $2,000, and, accordingly, A and B cannot become separate improvements upon the application of section 1250(f)(4)(A) or be considered under such section as improvements for purposes of determining whether other improvements are separate improvements. This result would not be changed if improvement C, costing $600, were added on December 15, 1960, since although the sum of the amounts added ($1,000 plus $600 plus $600, or $2,200) exceeds $2,000, such sum is less than 1 percent of the unadjusted basis of the property ($3,000, that is 1 percent of $300,000). If, however, C cost $1,500, then A, B, and C would each be considered an improvement and be taken into account for purposes of determining whether such improvements and other improvements are separate improvements.

The application of section 1250(f)(4) (A) and (B) is illustrated by the following example:

Example.—On January 1, 1970, X, a calendar-year taxpayer, sells a piece of section 1250 property which he purchased on January 1, 1958. In the table below, assume that each improvement was added on January 1 of the year shown.

Date	Improvements	Unadjusted basis	Adjusted basis
1958: Dec. 31		$100,000	$94,000
1959:			
Jan. 1	A $10,000		
Dec. 31		110,000	97,030
1960:			
Jan. 1	B 4,000		
Dec. 31		114,000	94,041
1961:			
Jan. 1	C 6,000		
Dec. 31		120,000	92,799
1962: Dec. 31		120,000	86,158
1963: Jan. 1	D 18,000		

Since the sum of the amounts added to the capital account of the section 1250 property for the 36-month period ending on December 31, 1961, is $20,000 (that is, $10,000 for A, plus $4,000 for B, plus $6,000 for C), and since this sum is less than $23,500 (that is, 25 percent of the adjusted basis ($94,000) of the section 1250 property immediately preceding the beginning of the period), there were no separate improvements on the property as of such date. Nevertheless C, as well as D, is a separate improvement, since the sum of the amounts added for the 36-month period ending December 31, 1963, is $24,000 (that is, $6,000 for C plus $18,000 for D), and this sum exceeds the greatest of—

(i) 25 percent of the adjusted basis ($94,041) of the section 1250 property as of December 31, 1961, or $23,510,

(ii) 10 percent of the unadjusted basis ($120,000) of the property as of such date, or $12,000, or

(iii) $5,000.

Paragraph (4)(B) of section 1250(f) further provides in effect that, solely for the purpose of determining the applicable percentage in respect of certain separate improvements, such separate improvements are treated as placed in service on that first day of a calendar month which is the first day of a calendar month closest to the middle of the

taxable year. If two such first days are equally close to the middle of the taxable year, the earliest of such days is the applicable day. In the case of a taxable year (other than a short taxable year) ending December 31, 1960, the applicable day is July 1, 1960. In the case of a taxable year beginning on January 1, 1963, and ending on November 29, 1963, the applicable day is June 1, 1963. This rule, which does not affect the date an improvement is added for purposes of paragraph (4)(A), applies only in respect of a separate improvement the amount of which does not exceed the greater of $2,000 or 1 percent of the unadjusted basis of the section 1250 property, determined as of the beginning of the taxable year in which the improvement is added to the property.

Paragraph (4)(C) of section 1250(f) provides that the term "improvement" means, in the case of any section 1250 property, any addition to capital account in respect of such property after its initial acquisition or completion. An addition to the capital account of section 1250 property may arise, for example, if there is an expenditure for section 1250 property which is an improvement, replacement, addition, or alteration to such property. In such a case, the "addition to capital account" is the gross addition, unreduced by amounts attributable to replaced property, to the net capital account and not the net addition to such account. Thus, if a taxpayer replaces a roof which has an adjusted basis of $20,000 by constructing a new roof at a cost of $50,000, the gross addition is $50,000 and, accordingly, the amount of the improvement is the "addition to capital account," $50,000. The $20,000 of adjusted basis of the old roof is no longer reflected in the basis of this property. If the new roof is a separate improvement, the holding period of the new roof begins on the date it is placed in service. An addition to capital account is an improvement whether it is capitalized or charged against the depreciation reserve. For purposes of section 1250(f), the status of an improvement is not affected by whether or not it is treated as a separate property for purposes of determining depreciation adjustments.

Any addition to capital account after the initial acquisition or completion of the section 1250 property is an improvement, even if the addition does not arise because of an expenditure for an improvement, replacement, addition, or alteration to the property. Thus for example the excess, if any, of the adjusted basis of section 1250 property in the hands of a transferee immediately after a transaction referred to in section 1250(e)(2) over its adjusted basis in the hands of the transferor immediately before the transaction is considered an improvement. Similarly, any excess of the adjusted basis of section 1250 property acquired in a transaction referred to in section 1250(e)(3) over the adjusted basis of the property disposed of, as well as any increase in the adjusted basis of section 1250 property of a partnership by reason of the application of section 734(b) or 743(b) of the code (relating to optional basis adjustments), is considered an improvement.

(*g*) *Adjustments to basis.*—Section 1250(g) provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain to which section 1250(a)(1) applies.

(*h*) *Application of section.*—Section 1250(h) provides that section 1250 applies notwithstanding any other provision of subtitle A of the code. Thus, section 1250 overrides any nonrecognition provision of

subtitle A or any "income characterizing" provision. For example, the gain to which section 1250(a)(1) applies might otherwise be considered as gain from the sale or exchange of a capital asset under section 1231 of the code (relating to property used in the trade or business and involuntary conversions). Since section 1250 overrides section 1231, the gain to which section 1250(a)(1) applies is treated as ordinary income, and only the remaining gain, if any, from the property may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. For example, assume that a taxpayer sells for $130 section 1250 property with an adjusted basis of $40 for a gain of $90. If, in respect of the property, the additional depreciation is $60 and the applicable percentage is 25 percent, the portion of the gain treated as gain under section 1250(a)(1) is $15 (that is, the applicable percentage (25 percent) of the lower of additional depreciation ($60) or the excess of amount realized over adjusted basis ($130 minus $40)). The residue of the gain ($90 minus $15, or $75) may be considered under section 1231 as gain from the sale of a capital asset.

Section 1250(h) is not intended to prevent gain not recognized under section 1250 from being considered as gain under another provision of the code. Thus, if the section 1250 property in the preceding example were sold in a transaction to which section 1239 of the code (relating to gain from sale of depreciable property between certain related persons) applies, $15 of the gain would be recognized as ordinary income under section 1250(a)(1) and nothing in section 1250(h) would prevent the remaining $75 of the gain from being treated as ordinary income under section 1239.

SECTION 220. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY (Continued)

(*b*) *Technical amendments.*—Paragraph (1) of section 220(b) of the bill amends section 170(e) of the code (relating to special rules for charitable contributions of certain property). Under existing law, section 170(e) provides that the amount of a charitable contribution of section 1245 property will be reduced by the amount which would have been treated (but was not actually treated) as gain to which section 1245(a) applies if the property had been sold at its fair market value instead of contributed to the charity. Under section 170(e) as amended, the same result is provided in the case of a charitable contribution of section 1250 property. Thus, for example, if gain of $4,000 would be recognized under section 1250(a)(1) upon a sale of section 1250 property at its fair market value of $17,000, then the amount of the charitable contribution under section 170(e) would be $13,000 ($17,000 minus $4,000).

Paragraph (2) of section 220(b) of the bill amends section 301 (b) and (d) of the code (relating to the amount distributed and basis in a corporate distribution of property) by striking out "under section 1245(a)" and inserting in lieu thereof "under section 1245(a) or 1250(a)".

Paragraph (3) of section 220(b) of the bill amends section 312(c)(3) of the code (relating to adjustments to earnings and profits) by striking out "or under section 1245(a)" and inserting in lieu thereof "or under section 1245(a) or 1250(a)".

Paragraph (4) of section 220(b) of the bill amends paragraph (12) of section 341(e) of the code (relating to collapsible corporations) by striking out "section 1245(a)" and inserting in lieu thereof "sections 1245(a) and 1250(a)".

Paragraph (5) of section 220(b) of the bill amends subparagraphs (A) and (B) of section 453(d)(4) of the code (relating to distribution of installment obligations in certain corporate liquidations) by striking out "section 1245(a)" and inserting in lieu thereof "section 1245(a) or 1250(a)".

Paragraph (6) of section 220(b) of the bill amends subsection (c) of section 751 of the code (relating to definition of "unrealized receivables" for purposes of subchapter K) by striking out "(as defined in section 1245(a)(3))" and inserting in lieu thereof "(as defined in section 1245(a)(3)) and section 1250 property (as defined in section 1250(c))" and by striking out "to which section 1245(a)" and inserting in lieu thereof "to which section 1245(a) or 1250(a)".

Paragraph (7) of section 220(b) of the bill amends the table of sections for part IV of subchapter P of chapter 1 of the code.

(*c*) *Effective date.*—Subsection (c) of section 220 of the bill provides that the amendments made by such section apply to dispositions after December 31, 1963, in taxable years ending after such date.

SECTION 221. AVERAGING

(*a*) *General rule.*—Subsection (a) of section 221 of the bill amends subchapter Q of chapter 1 of the code by substituting a new part I (secs. 1301–1305, relating to income averaging) for the existing part I (secs. 1301–1307, relating to income attributable to several taxable years).

SECTION 1301. LIMITATION ON TAX

Section 1301 provides that if an eligible individual (as defined in sec. 1303) has averagable income (as defined in sec. 1302(a)) for the computation year (as defined in sec. 1302(e)(1)), and if the amount of such income exceeds $3,000, then such individual may choose (pursuant to the provisions of sec. 1304(a)) to compute the tax attributable to his averagable income under section 1301.

Section 1301 provides that, for the computation year, the tax imposed by section 1 of the code which is attributable to the amount of an individual's averagable income for such year is equal to 5 times the increase in tax under section 1 of the code which would result from adding 20 percent of the individual's averagable income for the computation year to the sum of—

(1) 133⅓ percent of the individual's average base period income (as defined in sec. 1302(c)), and

(2) the amount (if any) of the individual's average base period capital gain net income (as defined in sec. 1302(d)(2)).

SECTION 1302. DEFINITION OF AVERAGABLE INCOME; RELATED DEFINITIONS

(*a*) *Averagable income.*—Section 1302(a) defines the term "averagable income."

In general

Paragraph (1) of section 1302(a) provides that the term "averagable income" means, except as provided in paragraph (2) of such section, the amount (if any) by which an individual's adjusted taxable income (as defined in sec. 1302(b)) for the computation year exceeds 133⅓ percent of his average base period income (as defined in sec. 1302(c)).

Adjustment in certain cases for capital gains

Paragraph (2) of section 1302(a) provides for an adjustment to averagable income where an individual's capital gain net income for the computation year is less than his average base period capital gain net income. Paragraph (2) provides that if an individual's average base period capital gain net income (as defined in sec. 1302(d)(2)) exceeds his capital gain net income (as defined in sec. 1302(d)(1)) for the computation year, then the term "averagable income" means the amount determined under paragraph (1) of section 1302(a) reduced by an amount equal to such excess. For example, if an individual's average base period capital gain net income is $5,000 and his capital gain net income for the computation year is $3,000, then the amount of his averagable income (determined under par. (1) of sec. 1302(a)) is reduced by $2,000.

(*b*) *Adjusted taxable income.*—Section 1302(b) provides that the term "adjusted taxable income" means the amount of an individual's taxable income for the computation year decreased by the sum of certain amounts. The term "adjusted taxable income" relates only to the amount which an individual takes into account, for purposes of averaging computations, in a computation year. If a computation year subsequently becomes a base period year, the amount of income for such year which is taken into account in any averaging computation is the base period income for such year, computed under section 1302(c)(2). An individual's adjusted taxable income is a computational amount for averaging purposes only and does not affect, for example, the amount of a credit or deduction based upon the income of a taxable year.

Capital gain net income for the computation year

Paragraph (1) of section 1302(b) provides that in determining an individual's adjusted taxable income for the computation year his taxable income for such year is decreased by the amount (if any) of the individual's capital gain net income (as defined in sec. 1302(d)(1)) for the computation year.

Income attributable to gifts, bequests, etc.

Paragraph (2) of section 1302(b) provides that in determining an individual's adjusted taxable income for the computation year his taxable income for such year is decreased by certain amounts of ordinary income attributable to interests in property which were received, during the computation year or any base period year, by the individual as a gift, bequest, devise, or inheritance, but only if the amount of such income for the computation year exceeds $3,000.

In general

Subparagraph (A) of section 1302(b)(2) provides the general rule that (in determining adjusted taxable income) an individual's taxable income for the computation year is decreased by the amount of net

income attributable to an interest in property where such interest was received by the individual as a gift, bequest, devise, or inheritance during the computation year or any base period year. The general rule does not, however, apply to income attributable to gifts, bequests, devises, or inheritances between husband and wife if they make a joint return (including a joint return filed by a survivor with his deceased spouse for the year of the death of such spouse), or if one of them makes a return as a surviving spouse (as defined in sec. 2(b) of the code), for the computation year. The general rule applies to income attributable to any interest in property received by an individual during the requisite years, whether the individual has legal or equitable ownership of the interest to which the income is attributable. Thus, income of an individual attributable to an interest in a trust is covered by the general rule.

Amount of net income

Subparagraph (B) of section 1302(b)(2) provides that, unless an individual otherwise establishes it to the satisfaction of the Secretary of the Treasury or his delegate, the amount of net income attributable to an interest in property to which subparagraph (A) applies is deemed to be 6 percent of the fair market value of such interest determined in accordance with the provisions of chapter 11 (relating to the estate tax) or chapter 12 (relating to the gift tax), as the case may be, of the code. Under this 6-percent rule, the amount of net income attributable to such an interest is not adjusted for any increase or decrease in the fair market value of the interest or any increase or decrease in the amount of income actually produced. However, an individual may establish for any taxable year that the amount of net income attributable to an interest in property is other than 6 percent of its value.

Limitation

Subparagraph (C) of section 1302(b)(2) limits the application of section 1302(b)(2) in any computation year to cases in which the sum of the net incomes attributable to interests in property described in subparagraph (A) of section 1302(b)(2) exceeds $3,000.

Net income

Subparagraph (D) of section 1302(b)(2) provides that the term "net income" means, with respect to any interest in property, the excess of the amount of the items of gross income attributable to such interest over the deductions properly allocable to or chargeable against such items. For purposes of computing net income, capital gains and losses are not taken into account.

Wagering income

Paragraph (3) of section 1302(b) provides that in determining an individual's adjusted taxable income for the computation year his taxable income for such year is decreased by the amount (if any) by which his gains from wagering transactions for the computation year exceed his losses from such transactions for such year. Thus (in determining adjusted taxable income), such individual's taxable income is reduced by the amount included in his gross income which is attributable to gains from wagering transactions and which exceeds his deduction for wagering losses under section 165(d) of the code.

Certain amounts received by owner-employees

Paragraph (4) of section 1302(b) provides that in determining an individual's adjusted taxable income for the computation year his taxable income for such year is decreased by the amounts (if any), described in section 72(m)(5)(A) of the code, to which a penalty under section 72(m)(5) of the code is applicable.

(*c*) *Average base period income.*—Section 1302(c) deals with the method by which an individual computes his average income for the base period.

In general

Paragraph (1) of section 1302(c) provides that the term "average base period income" means an amount which is one-fourth of the sum of an individual's base period incomes for the base period. The term "base period" is defined in section 1302(e)(2) as the 4 taxable years immediately preceding the computation year.

Base period income

Paragraph (2) of section 1302(c) provides that an individual's base period income for any taxable year is his taxable income for such year, first increased under subparagraph (A) of such paragraph and then decreased (but not below zero) under subparagraphs (B) and (C) thereof. For purposes of determining an individual's base period income for any taxable year, taxable income includes all of such individual's income and deductions for such taxable year. For example, certain accumulation distributions from trusts under section 666(a) of the code (relating to accumulation distribution allocated to 5 preceding years) are included in an individual's gross income for the taxable year in which such distributions are properly paid, credited, or required to be distributed to him even though the tax attributable to such distributions is determined in accordance with section 668 of the code (relating to treatment of amounts deemed distributed in preceding years). Similarly, if an individual restores an amount held under a claim of right to which section 1341 of the code applies, the amount of such restoration is (for purposes of determining base period income) a deduction from the individual's gross income for the taxable year of restoration.

Subparagraph (A) of section 1302(c)(2) provides that in determining an individual's base period income for any taxable year his taxable income for such year is increased by an amount equal to the excess (under clause (i)) of the amount excluded from gross income under section 911 of the code (relating to earned income from sources without the United States) and subpart D of part III of subchapter N of the code (sec. 931 and following, relating to income from sources within possessions of the United States) over the deductions (under clause (ii)) which would have been properly allocable to or chargeable against such amount but for the exclusion of such amount from gross income.

Subparagraph (B) of section 1302(c)(2) provides that in determining an individual's base period income for any taxable year his taxable income for such year is decreased by the amount of his capital gain net income for such year.

Subparagraph (C) of section 1302(c)(2) provides that if, for any computation year, an individual's taxable income includes an amount

of net income in excess of $3,000 attributable to gifts, bequests, devises, or inheritances (and, therefore, the individual's taxable income is decreased by the amount of such net income, pursuant to sec. 1302(b)(2)), then any amount (whether or not in excess of $3,000) of net income for any base period year attributable to gifts, bequests, devises, or inheritances received within the base period is subtracted from his taxable income for such year in computing his base period income for such year. In any case in which section 1302(b)(2) does not apply in the computation year, an individual's taxable income for any base period year is not decreased by any amount attributable to gifts, bequests, devises, or inheritances.

(*d*) *Capital gain net income, etc.*—Section 1302(d) contains definitions relating to capital gain net income.

Capital gain net income

Paragraph (1) of section 1302(d) provides that, for any taxable year beginning after December 31, 1963, the term "capital gain net income" means the amount (if any) by which (1) the sum of the adjusted class A capital gain (as defined in sec. 1222(c)(10) of the code as amended by sec. 219 of the bill) and the adjusted class B capital gain (as defined in sec. 1222(c)(9) of the code as amended by sec. 219 of the bill) exceeds (2) the deduction for capital gains allowable under section 1202(a) of the code (relating to deduction for capital gains). For any taxable year beginning before January 1, 1964, paragraph (1) of section 1302(d) provides that the term "capital gain net income" means the amount which is equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss. An individual's capital gain net income for any taxable year cannot be less than zero.

Average base period capital gain net income

Paragraph (2) of section 1302(d) provides that the term "average base period capital gain net income" means one-fourth of the sum of an individual's capital gain net incomes for his 4 base period years. However, for purposes of determining an individual's average base period capital gain net income, the amount of his capital gain net income for any single base period year may not exceed the amount of his base period income for such year, computed without regard to the decrease (if any) contained in section 1302(c)(2)(B) for capital gain net income for such base period year. For example, if an individual's base period income (before the application of sec. 1302(c)(2)(B)) for a base period year is $1,000, and if the amount of his capital gain net income for such year is $4,000, then, for purposes of computing his average base period capital gain net income he takes into account only $1,000 as his capital gain net income for such base period year.

(*e*) *Other related definitions.*—Section 1302(e) contains definitions of four other terms used in the averaging provisions.

Computation year

Paragraph (1) of section 1302(e) provides that the term "computation year" means the taxable year for which an eligible individual chooses under section 1304(a) the benefits of income averaging.

Base period

Paragraph (2) of section 1302(e) provides that the term "base period" means the 4 taxable years immediately preceding the taxable year which is the computation year.

Base period year

Paragraph (3) of section 1302(e) provides that the term "base period year" means any single taxable year which is one of the 4 taxable years immediately preceding the computation year.

Joint return

Paragraph (4) of section 1302(e) provides that the term "joint return" means the return of a husband and wife made under section 6013 of the code.

SECTION 1303. ELIGIBLE INDIVIDUALS

Section 1303 describes those individuals who are eligible to choose the benefits of income averaging.

(*a*) *General rule.*—Section 1303(a) provides that, except as otherwise provided in section 1303, the term "eligible individual" means any individual who is a citizen or resident of the United States throughout the computation year. Where a husband and wife make a joint return under section 6013 of the code, both the husband and wife must be eligible individuals in order to choose the benefits of income averaging.

(*b*) *Nonresident alien individuals.*—Section 1303(b) provides that an individual is not an eligible individual for the computation year if such individual was, at any time during such year or any of his base period years, a nonresident alien.

(*c*) *Individuals receiving support from others.*—Section 1303(c) deals with the eligibility of individuals receiving support from others.

In general

Paragraph (1) of section 1303(c) provides that an individual is not an eligible individual for the computation year if, for any base period year, such individual (and his spouse) furnished less than 50 percent of his support.

Exceptions

Paragraph (2) of section 1303(c) provides three exceptions to the general rule in paragraph (1).

Subparagraph (A) of section 1303(c)(2) provides that section 1303(c)(1) does not apply to any computation year if such year ends after the individual attained age 25 and if, during at least four of his taxable years beginning after he attained age 21 and ending with his computation year, he was not a full-time student.

The application of the rule contained in subparagraph (A) of section 1303(c)(2) is illustrated by the following example:

Example.—A, an unmarried U.S. citizen, was born in January 1937 and completed college in June 1958. He then entered military service, from which he was discharged in December 1960. For the taxable years 1961 and 1962 he was a full-time student in Y university and

furnished less than one-half of his support for those years. He was employed by Z corporation beginning in January 1963. If A is otherwise eligible, he may choose the benefits of income averaging for the taxable year 1964, notwithstanding the fact he furnished less than one-half of his support for each of his base period years (1960 through 1963), since the taxable year 1964 ends after he attained age 25 and he was not a full-time student for at least four of his taxable years beginning after he attained age 21 and ending with his computation year. That is, he was not a full-time student for 1959, 1960, 1963, and 1964.

Subparagraph (B) of section 1303(c)(2) provides that section 1303(c)(1) does not apply to any computation year if more than 50 percent of the individual's adjusted taxable income for the computation year is attributable to work performed by him in substantial part during 2 or more of his 4 base period years.

The application of the rule contained in subparagraph (B) of section 1303(c)(2) is illustrated by the following example:

Example.—B, an unmarried U.S. citizen who was born on January 15, 1945, is a calendar-year taxpayer. B, who had no income previously and whose parents have always furnished more than 50 percent of his support, sells for a large sum in 1964 a novel which he wrote in substantial part in 1962 and 1963. The proceeds of the sale constitute more than 50 percent of B's adjusted taxable income for 1964. Accordingly, B is an eligible individual in 1964 and, if he otherwise qualifies, may choose the benefits of income averaging.

Subparagraph (C) of section 1303(c)(2) provides that section 1303(c)(1) does not apply to any computation year if the individual makes a joint return for such year and not more than 25 percent of the aggregate adjusted gross income of such individual and his spouse for such year is attributable to such individual.

The application of the rule contained in subparagraph (C) of section 1303(c)(2) is illustrated by the following example:

Example.—H and W, who are U.S. citizens and calendar-year taxpayers, were married in August 1963. W's parents furnished more than 50 percent of her support for each year prior to her marriage. For 1964, H and W file a joint return showing an aggregate adjusted gross income of $10,000, all of which is attributable to H. If H and W are otherwise qualified under section 1301, they may choose the benefits of income averaging.

In applying subparagraph (C) to determine the amount of the aggregate adjusted gross income attributable to an individual, amounts of earned income (within the meaning of sec. 911(b) of the code) which are community income under community property laws applicable to such income are taken into account as if such amounts did not constitute community income.

(*d*) *Student defined.*—Section 1303(d) provides that, for purposes of section 1303, the term "student" means, with respect to a taxable year, an individual who during each of 5 calendar months during his taxable year either (1) was a full-time student at an educational institution (as defined in sec. 151(e)(4) of the code) or (2) was pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution (as defined in sec. 151(e)(4) of the code) or of a State or political subdivision of a State. When used in section 1303(d), the term "educa-

tional institution" has the same meaning as is given such term in section 151(e)(4) of the code.

SECTION 1304. SPECIAL RULES

(*a*) *Taxpayer must choose benefits.*—Section 1304(a) provides that part I of subchapter Q of the code applies to a taxable year only if the taxpayer chooses to have the benefits of income averaging for such taxable year. The taxpayer may make or change his choice of such benefits at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by chapter 1 of the code for the taxable year.

(*b*) *Certain provisions inapplicable.*—Section 1304(b) provides that certain sections of the code do not apply to an individual for a taxable year for which he chooses the benefits of income averaging. However, in the event that an individual who chooses the benefits of income averaging for any taxable year subsequently becomes ineligible for such benefits for such year, the sections of the code listed in section 1304(b) may be applied in the recomputation of the tax imposed by section 1 of the code upon the income of such individual. For example, if an individual has a net operating loss in a taxable year subsequent to a computation year, and if the carryback of such loss deduction affects the individual's income for the computation year so that the individual is no longer eligible (under sec. 1301) for the benefits of income averaging, then the provisions listed in section 1304(b), which are not available in a computation year, may apply to such individual since such year is no longer a computation year.

Paragraph (1) of section 1304(b) provides that section 3 of the code (relating to optional tax if adjusted gross income is less than $5,000) does not apply to an individual for any computation year. An individual may not, therefore, make use of the tax table contained in section 3 of the code for any year in which he chooses the benefits of income averaging.

Paragraph (2) of section 1304(b) provides that section 72(n)(2) of the code (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals) does not apply to any distribution received by an individual in a computation year.

Paragraph (3) of section 1304(b) provides that section 911 of the code (relating to earned income from sources without the United States) does not apply to an individual for a computation year. Thus, if an individual chooses the benefits of income averaging, he may not exclude from his gross income for the computation year any portion of his earned income from sources without the United States.

Paragraph (4) of section 1304(b) provides that subpart D of part III of subchapter N of the code (sec. 931 and following, relating to income from sources within possessions of the United States) does not apply to an individual for a computation year. Thus, if an individual chooses to have the benefits of income averaging, he may not exclude any portion of his income from sources within possessions of the United States from his gross income for the computation year.

(*c*) *Failure of certain married individuals to make joint return, etc.*—An individual who is or who has been married for any of the 5 years taken into account in an income averaging computation may be

required to reconstruct his income so that it properly reflects the comparison required by section 1301 between his income for the computation year and his average base period income. Section 1304(c) contains the rules under which an individual makes such a reconstruction of his income for any taxable year, whether it is a computation year or a base period year.

Application of subsection

Paragraph (1) of section 1304(c) provides that paragraphs (2), (3), and (4) of such section apply in the case of any individual who was married for any base period year or the computation year. This general rule is subject to the exceptions contained in subparagraphs (A) and (B) of paragraph (1).

Paragraph (1)(A) of section 1304(c) provides that paragraphs (2), (3), and (4) of such section do not apply to a base period year of an individual who was married for such year if (under clause (i)) such individual and his spouse make a joint return, or such individual makes a return as a surviving spouse (as defined in sec. 2(b) of the code), for the computation year, and (under clause (ii)) such individual was not married to any other spouse for such base period year. In any case in which married individuals make a joint return for the computation year and were both single, or were married to each other but filed separate returns, for any base period year, their separate base period incomes for such year are combined to achieve the required comparison between their aggregate income for such base period year and their aggregate income for the computation year. For example, if H and W (who are otherwise eligible to choose the benefits of averaging for 1964) were married in June 1963 (neither having been previously married) and made joint returns for 1963 and 1964, their aggregate base period incomes for 1960, 1961, and 1962 are the amounts for each such year which are equal to the sum of their separate base period incomes for each such year.

Paragraph (1)(B) of section 1304(c) provides that paragraph (4) of such section (relating to community income attributable to services) does not apply to the computation year of an individual who was married for such year if the individual and his spouse make a joint return for such computation year.

Minimum base period income

Paragraph (2) of section 1304(c) provides that, for purposes of income averaging, the base period income of an individual for any base period year cannot be less than 50 percent of the base period income which would result from combining his income and deductions for such year (under subpar. (A)) with the income and deductions for such year of the individual who is his spouse for the computation year, or (under subpar. (B)), if greater, with the income and deductions of the individual who was his spouse for such base period year. Thus, for example, at a minimum the base period income of an individual who is unmarried for his computation year but who was married for any base period year is an amount equal to 50 percent of the base period income (which results from the combination of income and deductions) of such individual and his spouse for such base period year.

The base period income of an individual who is married for the computation year and who was married to a different spouse for any

base period year is at least 50 percent of the aggregate base period income of the individual and his present spouse or, if greater, 50 percent of the aggregate base period income of the individual and his prior spouse for such base period year. The base period income of an individual who makes a return as a surviving spouse (as defined in sec. 2(b) of the code) for the computation year and who was married, in any base period year, to a spouse other than the spouse with respect to whom such return is made, is at least 50 percent of the aggregate base period income of such individual and his deceased spouse for the computation year or, if greater, 50 percent of the aggregate base period income of such individual and his spouse for such base period year.

The amount of base period income resulting from a computation under paragraph (2) of section 1304(c) is, however, only the minimum amount an individual must take into account as his base period income. In any case in which paragraph (2) of section 1304(c) applies, an individual must take into account as his base period income for a base period year the largest of the following amounts:

(1) The base period income resulting from his income and deductions for such year;

(2) An amount equal to 50 percent of the aggregate base period income resulting from the combined income and deductions of himself and the individual who is his spouse in the computation year; or

(3) An amount equal to 50 percent of the aggregate base period income resulting from the combined income and deductions of himself and the individual who was his spouse in the relevant base period year.

Minimum base period capital gain net income

Paragraph (3) of section 1304(c) deals with the minimum amount of capital gain net income which an individual must take into account for any base period year when such individual is required to determine his minimum base period income in accordance with paragraph (2) of section 1304(c). If paragraph (2) applies for any base period year, then an individual combines his capital gain net income for such year with the same individual with whom he combined his base period income under such paragraph.

Paragraph (3) of section 1304(c) provides that, for purposes of income averaging, the capital gain net income of any individual for any base period year cannot be less than 50 percent of the amount of capital gain net income which would result from combining his capital gain net income for such year (determined without regard to par. (3)) with the capital gain net income for such year (similarly determined) of the individual with whom he is required by paragraph (2) of section 1304(c) to combine his income and deductions for such year.

The application of the rule contained in section 1304(c)(3) is illustrated by the following example:

Example.—H was single for the taxable year 1960, married to A for the taxable years 1961 and 1962, divorced from A in the taxable year 1963, and married to B for the taxable year 1964. B was single for the taxable years 1960 through 1963. H and B make a joint return for 1964 and are eligible to choose the benefits of averaging. If H was required by section 1304(c)(2) to combine his income and deductions for the taxable years 1961 and 1962 with A, then H must

combine his capital gain net income for those years with A and treat not less than 50 percent of the resulting amount as his base period capital gain net income. In addition, for such years H must combine his capital gain net income with that of B in order to determine their aggregate capital gain net income for such years. Thus, H is required (1) to determine his portion of the aggregate capital gain net income (of himself and A) for the taxable years 1961 and 1962, and (2) to combine such portion with B's capital gain net income for such years. H must combine his capital gain net income for the taxable years 1960 and 1963 with B.

Community income attributable to services

Paragraph (4) of section 1304(c) deals with the treatment of amounts of earned income which are attributable to services and which are community income under community property laws applicable to such income. Subparagraph (A) of paragraph (4) deals with the treatment of such income in base period years, while subparagraph (B) deals with the treatment of such income in the computation year.

Subparagraph (A) of section 1304(c)(4) provides that, in the case of amounts which constitute earned income (within the meaning of sec. 911(b) of the code) and are community income under community property laws applicable to such income, the amount taken into account by an individual for any base period year for purposes of determining his base period income cannot be less than the amount which would be taken into account if such amounts did not constitute community income. Thus, if H and W had $10,000 of community income attributable to services for a base period year, all of which was attributable to H, then H must take the entire $10,000 into account in determining his base period income for such year. W must take $5,000 into account where she is determining her separate base period income for such year.

Subparagraph (B) of section 1304(c)(4) provides that, in the case of amounts which constitute earned income (within the meaning of sec. 911(b) of the code) and are community income under community property laws applicable to such income, the amount taken into account by an individual for purposes of determining adjusted taxable income for the computation year cannot exceed the amount which would be taken into account if such amounts did not constitute community income. Thus, if H and W's total income for a taxable year consists of $60,000 of community income attributable to services, $40,000 of which is attributable to H, and if H and W make separate returns for such taxable year and are individually eligible to choose the benefits of income averaging, then the amount of such income which H takes into account for determining his adjusted taxable income cannot exceed $30,000 and the amount of such income which W takes into account for determining her adjusted taxable income cannot exceed $20,000. The additional $10,000 of W's income for such year (which results from the application of community property laws) is not subject to income averaging.

Marital status

Paragraph (5) of section 1304(c) provides that, for purposes of such section, the provisions of section 143 of the code (relating to determination of marital status) apply in determining whether an individual is married for any taxable year.

(*d*) *Dollar limitations in case of joint returns.*—Section 1301 provides, in part, that the limitation on tax contained therein applies only if an eligible individual has an amount of averagable income for his computation year in excess of $3,000. Section 1304(d) provides that, in the case of a joint return for a computation year, the $3,000 figure contained in section 1301 applies to the aggregate averagable income of the taxpayers making the joint return.

Section 1302(b)(2)(C) provides that in determining an individual's adjusted taxable income for the computation year his taxable income for such year is decreased for gift, etc., income only if the sum of the net incomes attributable to interests in property described in section 1302(b)(2)(A) exceeds $3,000. Section 1304(d) provides that in the case of a joint return for a computation year, the $3,000 figure contained in section 1302(b)(2)(C) applies to the aggregate net incomes of the taxpayers making the joint return.

(*e*) *Special rules where there are capital gains.*—Section 1304(e) deals with the methods for determining (1) the tax attributable to the portion of adjusted gross income for the computation year that is attributable to capital gains, and (2) the alternative tax under section 1201(b) of the code (relating to the alternative tax on taxpayers other than corporations).

For purposes of the income-averaging provisions, an individual's income for the computation year must be divided into certain segments in order to determine the total amount of tax imposed by section 1 of the code for the computation year which is attributable to such income. Listed in ascending order from the standpoint of the tax rate brackets applicable to such segments of income, an individual's income for the computation year (for these purposes) consists of the following segments:

(1) An amount equal to the sum of 133⅓ percent of average base period income.

(2) The amount (if any) of the adjustment for capital gains made to averagable income under section 1302(a)(2).

(3) The amount (if any) of capital gain net income for the computation year which is less than or equal to average base period capital gain net income.

(4) Twenty percent of averagable income.

(5) The amount (if any) of certain other items of income (including, for example, amounts under sec. 1304(f)(1), relating to gift or wagering income).

(6) The amount (if any) of capital gain net income which exceeds average base period capital gain net income.

(7) The amount (if any) of other items of income (including, for example, amounts under sec. 1304(f)(2), relating to certain owner-employee amounts).

Treatment of capital gains in computation year

Paragraph (1) of section 1304(e) provides that, in the case of any individual who has capital gain net income for the computation year, the tax imposed by section 1 of the code for the computation year which is attributable to the amount of such net income is computed (under subpar. (A) of par. (1)) by adding so much of such net income as does not exceed the individual's average base period capital gain net income above 133⅓ percent of his average base period income, and

(under subpar. (B) of par. (1)) by adding the remainder (if any) of such net income above 20 percent of his averagable income as taken into account for purposes of computing the tax imposed by section 1 of the code (and above the amounts (if any) of his gift or wagering income, referred to in sec. 1304(f)(1)).

Example.—A, an eligible individual who was not married for the taxable years 1960 through 1964, has taxable income for those years as indicated in the table below. For the taxable years 1960 through 1963, all of his ordinary income is from salary and all of his capital gain is net long-term capital gain. For the taxable year 1964, A's ordinary income includes $5,000 of net income attributable to a bequest received by A in 1964. All of A's capital gain for 1964 is adjusted class A capital gain. The tax rates applicable to A's income for 1964 are those prescribed under the amendments made by section 111 of the bill.

A's eligibility to choose the benefits of income averaging under section 1304(a) and the amount of his averagable income for 1964 are determined in the following manner:

Year	Taxable income		
	Total	Ordinary income	Capital gains
1960	$8, 250	$2, 000	$12, 500
1961	7, 750	4, 000	7, 500
1962	7, 500	3, 500	8, 000
1963	8, 500	2, 500	12, 000
1964	59, 000	49, 000	25, 000

(1) Adjusted taxable income for 1964 (the computation year):

(*a*) Taxable income for 1964	$59, 000
Less:	
(*b*) (i) Capital gain net income for the computation year (40 percent of $25,000)	10, 000
(ii) Income attributable to bequest	5, 000
Total	15, 000
Adjusted taxable income	$44, 000

(2) Average base period income for years 1960–63 (the base period years):

(*a*) 1960	2, 000
1961	4, 000
1962	3, 500
1963	2, 500
	12, 000
(*b*) $12,000÷4	3, 000

(3) Average base period capital gain net income:

(*a*) 1960, $12,500×50 percent	6, 250
1961, $7,500×50 percent	3, 750
1962, $8,000×50 percent	4, 000
1963, $12,000×50 percent	6, 000
	20, 000
(*b*) $20,000÷4	5, 000

(4) Averagable income for 1964:	
(a) Adjusted taxable income	$44,000
Less:	
(b) 133⅓ percent of average base period income (4/3×$3,000)	4,000
Total	$40,000

Since A has an amount of averagable income which exceeds $3,000, he is eligible to choose the benefits of averaging. The entire amount ($40,000) of his averagable income is subject to averaging.

Computation of tax due for computation year (1964):

(1) Tax on the sum ($27,000) of the following amounts:	
(a) 133⅓ percent of the average base period income	$4,000
(b) The average base period capital gain net income	5,000
(c) 20 percent of the averagable income ($40,000÷5)	8,000
(d) Income attributable to bequest	5,000
(e) Excess of computation year capital gain net income over average base period capital gain net income	5,000
	$27,000
Tax on $27,000	$10,160
(2) Tax attributable to the averagable income:	
(a) Tax on $17,000	5,055
(b) Tax on 20 percent of averagable income ($5,055−$2,055)	3,000
(c) Multiply tax by 5 (5×$3,000)	15,000
(3) Tax attributable to the income attributable to bequest ($7,460−$5,055)	2,405
(4) Tax attributable to the excess of computation year capital gain net income over average base period capital gain net income ($10,160−$7,460)	2,700
(5) Total tax for 1964:	
(a) Tax on first $9,000 of income	2,055
(b) Tax on averagable income ($40,000)	15,000
(c) Tax on income attributable to bequest ($5,000)	2,405
(d) Tax on excess capital gain net income ($5,000)	2,700
Total	$22,160

Without the benefits of income averaging, the total tax for 1964 would be $28,555. Thus, the tax saving resulting from income averaging is $6,395.

If the amount of an individual's capital gain net income for the computation year is less than his average base period capital gain net income, then the tax imposed by section 1 of the code for the computation year which is attributable to the amount of such net income is computed by adding the amount of such net income to the amount equal to the sum of 133⅓ percent of the individual's average base period income plus the amount of the adjustment for capital gains made to his averagable income under section 1302(a)(2).

Example.—The facts are the same as in the example above, except that A's taxable income for 1964 is $47,000, of which $44,000 is ordinary income and the remaining $3,000 is attributable to his $7,500 adjusted class A capital gain.

(1) Adjusted taxable income for 1964 (the computation year):	
(a) Taxable income for 1964	$47,000
Less:	
(b) Capital gain net income for the computation year	3,000
Adjusted taxable income	$44,000

(2) Average base period income for years 1960–63 (the base period years)	$3, 000
(3) Average base period capital gain net income	5, 000
(4) Averagable income for 1964:	
(a) Adjusted taxable income	44, 000
Less:	
(b) 133⅓ percent of average base period income (4/3×$3,000)	4, 000
Total	$40, 000
Less:	
(c) The adjustment for capital gains:	
(i) Average base period capital gain net income 5, 000	
Less:	
(ii) Capital gain net income for the computation year 3, 000	
Total	2, 000
Averagable income	$38, 000

Since A has an amount of averagable income which exceeds $3,000, he is eligible to choose the benefits of averaging. The entire amount ($38,000) of his averagable income is subject to averaging.

Computation of tax due for computation year (1964):

(1) Tax on the sum ($16,600) of the following amounts:	
(a) 133⅓ percent of the average base period income and the adjustment for capital gains (4/3×$3,000+$2,000)	$6, 000
(b) The amount of the computation year capital gain net income	3, 000
(c) 20 percent of the averagable income ($38,000÷5)	7, 600
Total	$16, 600
Tax on $16,600	$4, 877
(2) Tax attributable to the averagable income:	
(a) Tax on $16,600	4, 877
(b) Tax on 20 percent of averagable income ($4,877−$2,055)	2, 822
(c) Multiply tax by 5 (5×$2,822)	14, 110
(3) Total tax for 1964:	
(a) Tax on first $9,000 of income	2, 055
(b) Tax on averagable income ($38,000)	14, 110
Total	$16, 165

Without the benefits of income averaging, the total tax for 1964 would be $21,705. Thus, the tax saving resulting from income averaging is $5,540.

Computation of alternative tax

Paragraph (2) of section 1304(e) deals with the method by which an individual computes his alternative tax under section 1201 of the code for any computation year. Paragraph (2) provides that if an individual has capital gain net income for the computation year, then section 1201(b) of the code is treated as imposing a tax on the individual's income which is equal to the tax imposed by section 1 of the code, reduced by the amount (if any) by which the amount of tax imposed by section 1 of the code which is attributable to an individual's capital gain net income for such year (as determined under paragraph (1) of sec. 1304(e)) exceeds the sum of 21 percent of the

adjusted class A capital gain and 25 percent of the adjusted class B capital gain for the computation year.

Therefore, an individual's alternative tax for the computation year is the total tax imposed by section 1 of the code upon his taxable income for such year reduced by the amount (if any) by which the amount of tax imposed by section 1 of the code upon segments (3) and (6) of his income (as described in the second paragraph of the discussion of sec. 1304(e), above) exceeds the sum of 21 percent of his adjusted class A capital gain and 25 percent of his adjusted class B capital gain.

Example.—The facts are the same as in the example above, except that A's taxable income for 1964 is $84,000, of which $44,000 is ordinary income and the remaining $40,000 is attributable to his $100,000 adjusted class A capital gain.

(1) Adjusted taxable income for 1964 (the computation year):	
(*a*) Taxable income for 1964	$84, 000
Less:	
(*b*) Capital gain net income for the computation year	40, 000
Adjusted taxable income	$44, 000
(2) Average base period income for years 1960–63 (the base period years)	$3, 000
(3) Average base period capital gain net income	$5, 000
(4) Averagable income for 1964:	
(*a*) Adjusted taxable income	$44, 000
Less:	
(*b*) 133⅓ percent of average base period income (4/3× $3,000)	4, 000
Total	$40, 000

Since A has an amount of averagable income which exceeds $3,000, he is eligible to choose the benefits of averaging. The entire amount ($40,000) of his averagable income is subject to averaging.

Computation of the tax due for computation year (1964):

(1) Tax on the sum ($52,000) of the following amounts:	
(*a*) 133⅓ percent of the average base period income	$4, 000
(*b*) The average base period capital gain net income	5, 000
(*c*) 20 percent of the averagable income ($40,000÷5)	8, 000
(*d*) Excess of computation year capital gain net income over average base period capital gain net income	35, 000
Total	$52, 000
Tax on $52,000	$25, 260
(2) Tax attributable to the averagable income:	
(*a*) Tax on $17,000	5, 055
(*b*) Tax on 20 percent of averagable income ($5,055 − $2,055)	3, 000
(*c*) Multiply tax by 5 (5× $3,000)	15, 000
(3) Tax attributable to the excess of computation year capital gain net income over average base period capital gain net income ($25,260 − $5,055)	20, 205
(4) Total tax for 1964:	
(*a*) Tax on first $9,000 of income	2, 055
(*b*) Tax on averagable income ($40,000)	15, 000
(*c*) Tax on excess capital gain net income ($35,000)	20, 205
Total	$37, 260

Computation of alternative tax for computation year (1964):

(1)	Tax equal to the tax imposed by sec. 1 of the code	$37, 260
(2)	Amount (if any) of reduction in tax:	
	(a) Tax imposed by sec. 1 of the code which is attributable to the amount of capital gain net income for the computation year which is equal to the average base period capital gain net income ($5,000)	1, 315
	(b) Tax imposed by sec. 1 of the code which is attributable to the excess of capital gain net income for the computation year over the average base period capital gain net income ($35,000)	20, 205
	Total tax attributable to capital gain net income for the computation year	21, 520
	(c) Amount which is 21 percent of adjusted class A capital gain for computation year ($100,000)	21, 000
	Reduction in tax	520
(3)	Alternative tax for 1964 ($37,260−$520)	$36, 740

Without the benefits of income averaging, the total tax for 1964 would be $41,130. Thus, the tax saving resulting from income averaging is $4,390.

(*f*) *Treatment of certain other items.*—Section 1304(f) deals with the treatment for purposes of income averaging of certain other items of income.

Gift or wagering income

Paragraph (1) of section 1304(f) provides that the tax imposed by section 1 of the code for the computation year which is attributable to the amounts by which an individual's taxable income was decreased under section 1302(b)(2) (relating to income attributable to gifts, bequests, etc.) and section 1302(b)(3) (relating to wagering income) equals the increase in tax under section 1 of the code which results from adding the amounts of such decreases above the 20 percent of the individual's averagable income as taken into account for purposes of computing the tax imposed thereon by section 1 of the code.

Section 72(m)(5)

Paragraph (2) of section 1304(f) provides that the provisions of section 72(m)(5) of the code which impose penalties upon certain amounts (described in sec. 72(m)(5)(A) of the code) received by owner-employees are to be applied as if part I of subchapter Q had not been enacted.

Other items

Paragraph (3) of section 1304(f) provides that, except as otherwise provided in part I of subchapter Q, the order and the manner in which any eligible individual to whom section 1301 applies for the computation year takes items of his income for the computation year and his base period into account, in computing the tax imposed by chapter 1 of the code on his income, is to be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

(*g*) *Short taxable years.*—Section 1304(g) provides that the provisions of part I of subchapter Q are to be applied to any computation year or base period year which is a short taxable year in the manner

provided in regulations by the Secretary of the Treasury or his delegate.

SECTION 1305. REGULATIONS

Section 1305 provides that the Secretary of the Treasury or his delegate will prescribe such regulations as may be necessary to carry out the purposes of part I of subchapter Q.

For example, in applying the averaging provisions, the Secretary of the Treasury or his delegate will prescribe appropriate adjustments where the taxable income of an individual includes distributions from trusts under section 666(a) of the code (relating to accumulation distribution allocated to 5 preceding years) if the tax attributable to such distributions is determined, as though such amounts had been distributed in preceding years, under the provisions of section 668 of the code (relating to treatment of amounts deemed distributed in preceding years).

SECTION 221. AVERAGING (Continued)

(*b*) *Repeal of section 72(e)(3)*.—Subsection (b) of section 221 of the bill repeals section 72(e)(3) of the code, which relates to the limit on the tax attributable to a lump sum amount described in section 72(e) of the code which is not received as an annuity.

(*c*) *Statute of limitations*.—Subsection (c) of section 221 of the bill amends subparagraph (B) of section 6511 (d)(2) of the code (relating to special period of limitation with respect to net operating loss carrybacks) by redesignating the existing language of the subparagraph as clause (i) and adding a new clause (ii). The new clause (ii) provides that, for purposes of the special period of limitation for filing a claim for credit or refund, such a claim for a computation year is determined to relate to an overpayment attributable to a net operating loss carryback when such carryback relates to any base period year. Thus, if (1) an individual has a net operating loss for a taxable year subsequent to a taxable year for which he had chosen the benefits of income averaging, and (2) such net operating loss carryback is wholly utilized in any one or more of his base period years preceding his computation year (which would result in an increased amount of averagable income for such computation year), the special period of limitation with respect to such individual's computation year applies and a timely claim for credit or refund with respect to the computation year may be filed. A deficiency which may result from the application of a net operating loss carryback to an individual's computation year may be assessed within the period allowed under section 6501(h) of the code (relating to limitation on assessment and collection for net operating loss carrybacks).

(*d*) *Technical amendments*.—Subsection (d) of section 221 of the bill makes technical amendments, reflecting the repeal of section 72(e)(3) of the code by subsection (b) of section 221 of the bill, to various provisions of sections 402 and 403 of the code.

(*e*) *Clerical amendments*.—Subsection (e) of section 221 of the bill makes clerical amendments to section 4(f) and section 5(b) of the code, and to the table of parts for subchapter Q of chapter 1 of the code.

(*f*) *Effective date.*—Section 221(f) of the bill provides the effective date for the amendments made by section 221 and continues the treatment of present law for certain compensation from an employment.

General rule

Paragraph (1) of section 221(f) provides that the amendments made by section 221 apply with respect to taxable years beginning after December 31, 1963. For computational purposes, however, taxable years beginning before January 1, 1964, may be taken into account as base period years.

Income from an employment

Paragraph (2) of section 221(f) provides that if, in a taxable year beginning after December 31, 1963, an individual or partnership receives or accrues compensation from an employment (as defined by sec. 1301(b) of the code as in effect immediately before the enactment of the bill) and the employment began before February 6, 1963, the tax attributable to such compensation may, at the election of the taxpayer, be computed under the provisions of sections 1301 and 1307 of the code as in effect immediately before the enactment of the bill. If a taxpayer so elects, at the time and in the manner prescribed by the Secretary of the Treasury or his delegate by regulations, he may not choose for such taxable year the benefits provided by part I of subchapter Q of chapter 1 of the code (relating to income averaging) as amended by section 221 of the bill.

SECTION 222. REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS

(*a*) *Repeal of tax.*—Subsection (a) of section 222 of the bill, by amending section 1503(a) of the code, repeals the 2-percent increase in tax applicable under existing law to corporations which file, or are required to file, a consolidated return under chapter 6 of subtitle A of the code. Section 1503(a) presently provides, in part, that the tax imposed under section 11(c) or section 831 of the code is increased for any taxable year by 2 percent of the consolidated taxable income of an affiliated group of includible corporations. Section 1503(a) as amended by this section of the bill contains no provision for any increase in tax. The computation of the tax liability of an affiliated group of corporations filing a consolidated return for a taxable year beginning in 1963 and ending in 1964 is made under section 21 of the code.

(*b*) *Technical and conforming amendments.*—Subsection (b) of section 222 of the bill (containing pars. (1) through (8)) makes technical and conforming amendments to various sections of the code to reflect the repeal of the 2-percent increase in tax and the rearrangement of certain provisions affected by such repeal.

(*c*) *Effective date.*—Subsection (c) of section 222 of the bill provides that the amendments made by subsections (a) and (b) of such section apply with respect to taxable years beginning after December 31, 1963.

SECTION 223. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS, ETC.

(*a*) *In general.*—Subsection (a) of section 223 of the bill adds a new part II to subchapter B of chapter 6 of the code (pertaining to related rules for consolidated returns). The new part contains three new sections, section 1561 (relating to surtax exemptions in case of certain controlled corporations), section 1562 (relating to privilege of groups to elect multiple surtax exemptions), and section 1563 (relating to definitions and special rules).

In general, the new section 1561 provides that certain members of a controlled group of corporations are entitled to a single $25,000 surtax exemption (to be divided among the members of the group) in lieu of the multiple surtax exemptions which may be available to these corporations under existing law. However, section 1561 is not applicable to the members of a controlled group of corporations if, under the new section 1562, the group elects the privilege of retaining multiple surtax exemptions. In such case, each member of the group will pay the additional tax imposed by section 1562(b). The new section 1563 contains certain definitions (including the definition of a "controlled group of corporations") and special rules for purposes of the new part II.

SECTION 1561. SURTAX EXEMPTIONS IN CASE OF CERTAIN CONTROLLED CORPORATIONS

(*a*) *General rule.*—Section 1561(a) provides the general rule for determining the amount of the surtax exemption of a corporation which is a component member (as defined in sec. 1563(b)) of a controlled group of corporations. The amount determined under section 1561(a) is to be used for purposes of subtitle A of the code, and where applicable is in lieu of the $25,000 amount specified in section 11(d) of the code (as amended by sec. 121 of the bill). In addition, a corporation which is a component member of a controlled group of corporations and which computes its tax by reference to the amount of the surtax exemption provided by section 11 is also affected. For example, section 511(a)(1) of the code imposes a tax on the unrelated business taxable income of the organizations described in section 511(a)(2). This tax is "computed as provided in section 11." If an organization which has income subject to tax under section 511 is a component member of a controlled group of corporations on a December 31, the computation of the tax liability of such organization for its taxable year including such December 31 is computed by reference to a surtax exemption in the amount determined under section 1561(a), in lieu of the $25,000 amount otherwise provided by section 11.

Paragraph (1) of section 1561(a) provides that the surtax exemption of a corporation which is a component member of a controlled group of corporations on a December 31, for its taxable year which includes such December 31, will be an amount equal to $25,000 divided by the number of corporations which are component members of such group on such December 31. However, paragraph (2) of section 1561(a) provides that in lieu of this pro rata share, such component members

may consent to an apportionment plan at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes. If a plan is properly consented to, the $25,000 will be apportioned among the corporations in accordance with such plan. Such a plan may be changed in future years. In no event, however, may the sum of the amounts apportioned among the component members of a group under paragraph (2) of section 1561(a), or the surtax exemption of any one corporation, exceed $25,000.

If the surtax exemption of a corporation for its taxable year beginning in 1963 and ending in 1964 is less than $25,000 by reason of the application of section 1561(a), the computation of such corporation's tax liability for such taxable year is made under section 21 of the code. See section 21(d) as amended by section 132 of the bill.

The provisions of section 1561(a) are illustrated by the following examples:

Example (1).—Corporations W, X, Y, and Z are component members of a controlled group of corporations on December 31, 1964, and each corporation files its income tax return on the basis of a calendar year. For their taxable years ending on December 31, 1964, corporations W and X each incur a net operating loss; corporation Y has $5,250 of taxable income; and corporation Z has $30,000 of taxable income. If the four corporations do not consent to an apportionment plan under section 1561(a)(2), the surtax exemption of each corporation will be $6,250 ($25,000 divided by 4). However, by consenting to an apportionment plan under section 1561(a)(2), the four corporations may avoid a pro rata division of the $25,000 amount (and the consequent wastage of the $6,250 allocated to corporations W and X, and $1,000 of the $6,250 allocated to corporation Y) and may agree to apportion the $25,000 amount in any manner they deem proper—for example, $25,000 to Z.

Example (2).—Corporation A files its income tax return on the basis of a calendar year; corporation B files its income tax return on the basis of a fiscal year ending on March 31. If corporations A and B are the only component members of a controlled group of corporations on December 31, 1964, the surtax exemption of A for its calendar year ending December 31, 1964, and the surtax exemption of B for its fiscal year ending March 31, 1965, are each in an amount equal to $12,500 ($25,000 divided by 2) under section 1561(a)(1) or, if an apportionment plan is filed under section 1561(a)(2), are in the amounts apportioned pursuant to such plan.

(*b*) *Certain short taxable years*.—Section 1561(b) provides a rule for determining the amount of the surtax exemption of a corporation which has a short taxable year (as described in sec. 443(a) of the code) that does not include a December 31 and which is a component member of a controlled group of corporations on the last day of such short taxable year. The amount of the surtax exemption of such corporation is equal to $25,000 divided by the number of corporations which are component members of such group on the last day of the short taxable year.

The determination of whether a corporation is a component member of a controlled group of corporations on the last day of a short taxable year is made by applying the definition of component member contained in section 1563(b) as if the last day of such short taxable year were substituted for the date "December 31" wherever it appears

in section 1563 (b). If a corporation's surtax exemption for a short taxable year is determined under section 1561(b) and the corporation makes a return for such short taxable year under section 443(a)(1) of the code (relating to a return for a year in which a taxpayer changes its annual accounting period), the amount determined under section 1561(b) will be used in lieu of the $25,000 amount otherwise applicable in the computation of tax liability for the short taxable year under section 443(b).

The provisions of section 1561(b) are illustrated by the following example:

Example.—On January 2, 1964, corporation P transfers cash to newly formed corporation T (which begins business on that date) and receives all the stock of corporation T in return. Corporation P also owns all the stock of corporation S on each day of 1963 and 1964. Corporation P uses the calendar year and corporation S uses a fiscal year ending on August 31 for their taxable years. Corporation T adopts a fiscal year ending on June 30 as its annual accounting period and, therefore, has a short taxable year during the first year of its existence, which begins on January 2, 1964, and ends on June 30, 1964. On June 30, 1964, corporation T is a component member of a parent-subsidiary controlled group of corporations of which corporation P is the common parent and corporations P, S, and T are component members. Accordingly, the surtax exemption of corporation T for its short taxable year ending on June 30, 1964, is $8,333.33 ($25,000 divided by 3). On December 31, 1964, corporations P, S, and T are component members of a parent-subsidiary controlled group of corporations. Accordingly, the surtax exemption of each such corporation for its taxable year including December 31, 1964 (i.e., P's calendar year ending December 31, 1964, S's fiscal year ending August 31, 1965, and T's fiscal year ending June 30, 1965) is $8,333.33 ($25,000 divided by 3) under section 1561(a)(1), or, if an apportionment plan is filed under section 1561(a)(2), is the amount apportioned to such corporation pursuant to such plan.

SECTION 1562. PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS

(*a*) *Election of multiple surtax exemptions.*—Under paragraph (1) of section 1562(a), a controlled group of corporations has the privilege of electing to have each of its component members (as defined in sec. 1563(b)) make its income tax returns without regard to section 1561 (relating to surtax exemptions in the case of certain controlled corporations). An election under paragraph (1) of section 1562(a) is to be made by a controlled group of corporations, with respect to a December 31 specified by the group, in the manner and time prescribed in section 1562(e) and the regulations thereunder. Under subparagraph (A) of section 1562(a)(1), the election is valid only if each corporation which was a component member of the electing controlled group on the specified December 31 consents to the election. If a controlled group retroactively makes an election by specifying a December 31 other than the December 31 immediately preceding the date on which the election is filed, subparagraph (B) of section 1562 (a)(1) requires the consent of each other corporation which was a

component member of the group on any December 31 succeeding the specified December 31 and preceding the date on which the election is filed, in addition to the consents of the corporations which are component members on the specified December 31.

Years for which effective

Paragraph (2) of section 1562(a) provides that a valid election under paragraph (1) is effective with respect to the taxable year of each component member of the electing controlled group of corporations which includes the specified December 31 and also is effective (without renewal) for each taxable year of each corporation which is a component member of the group (or a successor group) on a succeeding December 31 included within such taxable year, unless the election is terminated under section 1562(c). Accordingly, an election under paragraph (1) of section 1562(a) affects not only the tax liability of corporations which are component members of an electing controlled group on the December 31 specified in the election, but it also affects the tax liability of corporations which are component members of the electing group on a December 31 subsequent to the specified December 31.

The provisions of section 1562(a) (1) and (2) are illustrated by the following examples:

Example (1).—Corporation P is the common parent of a parent-subsidiary controlled group of corporations of which corporations P, X, and Y are component members on December 31, 1964. On December 31, 1965, the controlled group of corporations consists of the same component members as on December 31, 1964, except that corporation Z is also a component member on December 31, 1965. On December 31, 1966, the controlled group of corporations consists of the same component members as on December 31, 1965, except that corporation X is no longer a component member on December 31, 1966. Assume that in January 1967 this controlled group of corporations makes an election under section 1562(a)(1) designating December 31, 1964, as the specified December 31. Corporations P, X (even though not a member of the group in January 1967), Y, and Z (even though it was not a member on December 31, 1964) must and do consent to this election to make the election valid. Under section 1562(a)(2), the election (unless terminated) is effective with respect to the taxable years of corporations P, X, and Y which include December 31, 1964. The election is also effective (unless terminated) with respect to the taxable years of corporations P, X, Y, and Z which include December 31, 1965, and with respect to the taxable years of corporations P, Y, and Z which include December 31, 1966.

Example (2).—Assume the same facts as in example (1) and that on December 31, 1967, the controlled group of corporations consists of the same component members as on December 31, 1966 (corporations P, Y, and Z), except that corporation T is also a component member on December 31, 1967. In such case, the election is effective (unless terminated) with respect to the taxable years of corporations P, Y, Z, and T which include December 31, 1967.

Effect of election

Paragraph (3) of section 1562(a) provides that, for any taxable year of a corporation with respect to which an election under paragraph (1) is effective, section 1561 does not apply, but the additional tax imposed by section 1562(b)(1) applies to such corporation for such taxable year. Thus, for each such taxable year the corporation is not denied a separate $25,000 surtax exemption by section 1561 but it is required to pay the additional tax imposed by section 1562(b)(1). However, if the surtax exemption is disallowed to the corporation under section 269 or 1551 of the code, the additional tax does not apply; see section 269(d) (as added by sec. 223(c) of the bill) and section 1551(c) (as amended by sec. 223(b) of the bill).

(*b*) *Additional tax imposed.*—Paragraph (1) of section 1562(b) imposes a tax on the taxable income of a corporation for the taxable year of such corporation with respect to which an election under section 1562(a)(1) is effective. This tax is in addition to taxes imposed by other sections of the code on such corporation for such taxable year. The additional tax imposed by paragraph (1) is equal to 6 percent of so much of a corporation's taxable income for a taxable year as does not exceed $25,000. In computing the tax liability of a corporation which is subject to the additional tax imposed by paragraph (1) for a taxable year which begins in 1963 and ends in 1964, section 21 of the code is applicable. See section 21(d)(2) (as amended by sec. 132 of the bill).

The last sentence of paragraph (1) of section 1562(b) provides an exception to the imposition of the additional tax on the taxable income of a component member of an electing controlled group of corporations. The additional tax is not applicable to the taxable year of a corporation if no other corporation which is a component member of such controlled group on the December 31 included in such corporation's taxable year has taxable income for its taxable year including such December 31. However, the application of this rule does not constitute a termination of an election and, therefore, an election by a controlled group would continue in effect for any succeeding year unless terminated under section 1562(c).

Tax treated as imposed by section 11, etc.

Paragraph (2) of section 1562(b) provides that if a corporation is subject to the tax imposed by section 11 of the code for a taxable year, and for the same taxable year the corporation is also subject to the additional tax imposed by paragraph (1) of section 1562(b), then the additional tax is treated for purposes of the code as a tax imposed by section 11. It is so treated, for example, for purposes of section 38 of the code (relating to credit against tax for investment in certain depreciable property) which allows a credit against the tax imposed by chapter 1 of subtitle A of the code. In addition, paragraph (2) of section 1562(b) provides that if a corporation is subject to a tax imposed by any section of the code other than section 11 but such tax is computed by reference to section 11, the additional tax imposed by paragraph (1) of section 1562(b) is treated for purposes of the code as imposed by such other section. Thus, for example, the tax imposed by section 831(a) of the code is "computed as pro-

vided in section 11"; therefore if a corporation is subject to both the tax imposed by section 831(a) and the additional tax under paragraph (1) of section 1562(b) for any taxable year, the additional tax is treated as imposed by section 831 for such taxable year. If section 1201 of the code is applicable, the additional tax applies only to the taxable income reduced by the excess of the net long-term capital gain over the net short-term capital loss.

Taxable income defined

Paragraph (3) of section 1562(b) provides that if certain special types of corporations are component members of a controlled group of corporations which has made a valid election under section 1562(a)(1), then for purposes of applying paragraphs (1) and (2) of section 1562(b) with respect to such corporations the term "taxable income" means—

(A) in the case of a corporation subject to tax under section 511 of the code, its unrelated business taxable income (within the meaning of sec. 512);

(B) in the case of a life insurance company, its life insurance company taxable income (within the meaning of sec. 802(b) of the code);

(C) in the case of a regulated investment company, its investment company taxable income (within the meaning of sec. 852(b)(2) of the code); and

(D) in the case of a real estate investment trust, its real estate investment trust taxable income (within the meaning of sec. 857(b)(2) of the code).

Special rules

Paragraph (4) of section 1562(b) contains a special rule to be used for purposes of certain sections of the code in which the normal tax rate or the surtax rate (or both) of a corporation subject to the additional tax imposed by paragraph (1) of section 1562(b) must be determined. Paragraph (4) provides that sections 244 (relating to dividends received on certain preferred stock), 247 (relating to dividends paid on certain preferred stock of public utilities), 804(a)(3) (relating to deduction for partially tax-exempt interest in the case of a life insurance company), and 922(2)(B) (relating to special deduction for Western Hemisphere trade corporations) are to be applied without regard to the additional tax imposed by paragraph (1) of section 1562(b). Thus, for example, in the case of a corporation subject to the tax imposed by section 11 and the additional tax imposed by paragraph (1) of section 1562(b) for its taxable year ending December 31, 1967, the deduction under section 244 of the code for such taxable year would be computed by using the fraction fourteen forty-eighths.

(*c*) *Termination of election.*—An election by a controlled group of corporations under section 1562(a) is terminated by any one of the occurrences described in paragraphs (1), (2), (3), and (4) of section 1562(c).

Consent of the members

Under paragraph (1) of section 1562(c), a controlled group of corporations may voluntarily terminate an election made under section 1562(a) by filing a termination of the election in the manner and time

prescribed by section 1562(e) and the regulations thereunder. The termination of an election is made with respect to a December 31 specified by the controlled group. The rules designating which component members of a controlled group of corporations are required to consent (and thus validate the termination) are similar to the rules with respect to an election under section 1562(a). Thus, each corporation which is a component member of the group on the specified December 31 must consent to the termination and, if a controlled group retroactively terminates an election with respect to a December 31 other than the December 31 immediately preceding the day on which the termination is filed, each other corporation which was a component member of such group on any December 31 succeeding the specified December 31 and preceding the day on which the termination is filed must consent.

Refusal by new member to consent

Under paragraph (2) of section 1562(c), an election is terminated by the refusal of a new member of a controlled group of corporations to consent to an election which is in effect with respect to such group. In order for a new member to terminate the group's election, the new member must file a statement that it does not consent to the election. Such statement must be filed within the time and in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate. A new member of a controlled group is a corporation which on December 31 of any year is a component member of a controlled group of corporations and on the immediately preceding January 1 was not a member (within the meaning of sec. 1563(a)) of such group.

Consolidated returns

Under paragraph (3) of section 1562(c), an election by a controlled group of corporations is terminated if—

(A) a corporation is a component member (determined without regard to the "additional member" rules provided in sec. 1563 (b)(3)) of such group on a December 31 included within a taxable year ending on or after January 1, 1964, and

(B) such corporation is a member of an affiliated group of corporations which makes a consolidated return under chapter 6 of the code (sec. 1501 and following) for such taxable year.

Thus, for example, a controlled group of corporations is, in effect, precluded from making an election under section 1562(a) with respect to the December 31 included within the taxable year of a component member of such group if such member joins in the filing of a consolidated return with respect to such taxable year.

Controlled group no longer in existence

Under paragraph (4) of section 1562(c), an election terminates if the electing controlled group of corporations is considered as no longer in existence with respect to any December 31. The determination of whether a controlled group of corporations is considered as no longer in existence for purposes of paragraph (4) is made under section 1562 (f)(1) and the regulations thereunder.

Years for which termination effective

The termination of an election under paragraph (1), (2), (3), or (4) of section 1562(c) is effective with respect to the December 31

referred to in the particular paragraph of such section under which the termination occurs. An election, once terminated, is no longer effective. Thus, a termination is effective with respect to the taxable year of each component member of a controlled group of corporations which includes such December 31 and with respect to all succeeding taxable years of each corporation which is a component member of the group. Moreover, the group may not make a new election, except as provided in section 1562(d).

(*d*) *Election after termination.*—Section 1562(d) provides that if a controlled group of corporations has made a valid election under section 1562(a) and the election is terminated under section 1562(c), the group (or any successor group within the meaning of sec. 1562(f)(1)(B)) is not eligible to make an election with respect to any December 31 before the sixth December 31 after the December 31 with respect to which the termination was effective.

The provisions of section 1562(d) are illustrated by the following example:

Example.—In 1967, a controlled group of corporations makes a valid election under section 1562(a) in which December 31, 1964, is designated as the "specified December 31." In 1968, the group files a termination of its election under section 1562(c)(1) in which December 31, 1965, is designated as the "specified December 31." Such termination is effective with respect to the taxable year of each component member of the group which includes December 31, 1965, and for all succeeding taxable years of each corporation which is a component member of the group. Thus, the election is effective only with respect to the taxable year of each component member of the group which includes December 31, 1964. Moreover, under section 1562 (d), the group (and any successor group) is not eligible to make another election with respect to any December 31 before December 31, 1971 (i.e., the sixth December 31 after December 31, 1965, the December 31 with respect to which the termination was effective under sec. 1562(c)(1)).

(*e*) *Manner and time of giving consent and making election, etc.*—Section 1562(e) provides that an election under section 1562(a)(1), a termination under section 1562(c)(1), and the consents of the corporations which are required to validate such election or termination are to be made in such manner as the Secretary of the Treasury or his delegate by regulations prescribes and at the time provided in paragraph (1) or (2) of section 1562(e).

Paragraph (1) of section 1562(e) provides that an election under section 1562(a) by a controlled group of corporations must be made before the expiration of 3 years after the date on which the income tax return for the taxable year of the component member of the controlled group which has the taxable year ending first on or after the specified December 31 is required to be filed (without regard to any extensions of time). Thus, for example, an election with respect to December 31, 1964, by a controlled group of corporations consisting of 2 calendar-year corporations could not be made after March 15, 1968. If, in the preceding example, both corporations had fiscal years in lieu of calendar years and one of the corporations had a taxable year ending January 31, 1965, and the other corporation had a taxable year ending June 30, 1965, the last day on which an election could be made with respect to December 31, 1964, is April 15, 1968.

Paragraph (2) of section 1562(e) provides that a termination under section 1562(c)(1) with respect to any December 31 must be made before the expiration of 3 years after such December 31.

The last sentence of section 1562(e) provides that a consent by a corporation to an election or termination, and the failure of a corporation which is a new component member described in section 1562(c)(2) to file a statement that it does not consent to an election of a controlled group of corporations, is deemed to be a consent to the application of section 1562(g)(1) (relating to tolling of statute of limitations on assessment of deficiencies) with respect to such corporation.

(*f*) *Special rules.*—Paragraph (1) of section 1562(f) provides that the determination of whether a controlled group of corporations is considered as no longer in existence with respect to any December 31, or is a successor to another controlled group of corporations and, in the case of the latter determination, the effect which the determination has with respect to any election or termination made by the predecessor or successor controlled group of corporations, is to be made under regulations prescribed by the Secretary of the Treasury or his delegate. Thus, regulations prescribed pursuant to the authority granted by section 1562(f) will provide rules for determining whether a controlled group of corporations is considered as no longer in existence with respect to any December 31 within the meaning of section 1562(c)(4). The regulations might appropriately provide, for example, that a controlled group of corporations remains in existence under the following circumstances: Corporations P and S file their returns on the basis of the calendar year. Corporation P owns all the stock of corporation S from January 1, 1965, through December 1, 1965. On December 2, 1965, corporation P sells the stock of S to the public. After December 2, 1965, a controlled group of corporations (within the meaning of sec. 1563(a)) is not in existence. However, corporations P and S will be additional members pursuant to section 1563(b)(3) and, therefore, component members of a controlled group of corporations on December 31, 1965. Accordingly, the controlled group of corporations consisting of corporations P and S did not go out of existence with respect to such December 31. Thus, if an election under section 1562(a) was in effect with respect to December 31, 1964, the election would not be terminated under section 1562(c)(4) with respect to December 31, 1965.

Regulations promulgated pursuant to the authority granted the Secretary of the Treasury or his delegate under paragraph (1) of section 1562(f) to provide rules for determining whether a controlled group of corporations is a successor to another controlled group of corporations are required by the last sentence of section 1562(f)(1) to be based on the continuation (or termination) of predominant equitable ownership. For example, assume that corporation X is the common parent of a controlled group of corporations which is not eligible to make an election by virtue of section 1562(d). Corporation X merges into corporation Y, a common parent of a controlled group of corporations with respect to which an election under section 1562(a) is in effect. Corporation Y (and not corporation X) is the surviving legal entity after the merger. If the stockholders of corporation X acquire, as a result of the merger, more than 50 percent of the equitable ownership of corporation Y, the regulations might appropriately provide that the group resulting from the

merger is a successor to the controlled group of which corporation X was the common parent. Thus, the successor group would be subject to the same limitations on making an election as were applicable to the group of which corporation X was the common parent. Correspondingly, the group of which corporation Y was the common parent prior to the merger would be considered as no longer in existence within the meaning of section 1562(c)(4), and the election of such group would be terminated.

Certain short taxable years

Paragraph (2) of section 1562(f) provides a special rule with respect to corporations which have a short taxable year not including a December 31. If one or more corporations have such short taxable years and are component members of a controlled group of corporations with respect to such taxable years (determined by applying sec. 1563(b) as if the last day of each such taxable year were substituted for December 31), then an election by such group under section 1562(a) is applicable with respect to such corporations with respect to such taxable years, provided the requirements of either subparagraph (A) or (B) of section 1562(f)(2) are met.

Subparagraph (A) of section 1562(f)(2) provides that if an election is in effect with respect to both the December 31 immediately preceding the short taxable years (not including a December 31) and the December 31 immediately succeeding the short taxable years, such election will apply with respect to such short taxable years.

Subparagraph (B) of section 1562(f)(2) provides that if an election is in effect with respect to either the December 31 immediately preceding or succeeding the short taxable years (not including a December 31) and each corporation with a short taxable year files a consent to the application of such election to its short taxable year, such election will apply with respect to such short taxable year. A consent under subparagraph (B) must be filed at such time and in such manner as the Secretary of the Treasury or his delegate prescribes by regulations.

(*g*) *Tolling of statute of limitations.*—Section 1562(g) provides for a tolling of the statute of limitations with respect to (1) the assessment of deficiencies, and (2) the credit or refund of overpayments, which are attributable to the application of part II of subchapter B of chapter 6 of the code.

Paragraph (1) of section 1562 provides that the statutory period for assessment of any deficiency against a corporation which is a component member of a controlled group of corporations for any taxable year, to the extent such deficiency is attributable to the application of the new part II, will not expire before the expiration of 1 year after the date the election or termination under section 1562 is made.

Paragraph (2) of section 1562 provides that if credit or refund of any overpayment of tax by a corporation which is a component member of a controlled group of corporations for any taxable year is prevented, at any time on or before the expiration of 1 year after the date an election or termination under section 1562 is made, by the operation of any law or rule of law, credit or refund of such overpayment may

nevertheless be allowed or made, to the extent such overpayment is attributable to the application of the new part II, if claim therefor is filed on or before the expiration of such 1-year period.

For purposes of section 1562(g), the date when an election under section 1562(a) or termination under section 1562(c)(1) is made is the date when the election or termination is filed. Thus, for example, assume that on December 1, 1968, a controlled group of calendar-year corporations files an election under section 1562(a) designating December 31, 1965, as the specified December 31. The statute of limitations for the assessment of deficiencies and for the credit or refund of overpayments for the taxable years of the component members of the controlled group ending on December 31, 1965, otherwise expires March 15, 1969, which date is less than 1 year after December 1, 1968 (the date when the election is filed). Section 1562(g)(1) provides that the statutory period for assessing deficiencies attributable to the application of the new part II for the taxable years of the component members of the group ending on December 31, 1965, does not expire before December 1, 1969.

SECTION 1563. DEFINITIONS AND SPECIAL RULES

(*a*) *Controlled group of corporations.*—Section 1563(a) defines the term "controlled group of corporations" for purposes of the new part II of subchapter B of chapter 6 of the code and provides rules for determining whether a corporation is a member of such a group. Included in the definition are four classifications of controlled groups of corporations. Paragraph (1) of section 1563(a) defines a "parent-subsidiary controlled group" and paragraph (2) defines a "brother-sister controlled group." Paragraphs (3) and (4) deal with two additional classifications of controlled groups—"combined groups" and "certain insurance companies."

Parent-subsidiary controlled group

Paragraph (1) of section 1563(a) defines a parent-subsidiary controlled group of corporations, in general, as one or more chains of corporations connected through stock ownership with a common parent corporation. For purposes of paragraph (1), a chain of corporations includes the common parent corporation and, therefore, may consist of only two corporations, one of which is a common parent corporation.

Subparagraph (A) of section 1563(a)(1) provides that in order for a corporation to be a member of a parent-subsidiary controlled group, stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation (except the common parent corporation) must be owned (within the meaning of sec. 1563(d)(1)) by one or more of the other corporations in the chain. In determining whether stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote of a corporation is so owned, all classes of such stock are aggregated; it is not necessary that 80 percent of each class of voting stock be so owned. Likewise, in determining whether stock possessing at least 80 percent of the total value of shares of all classes of stock is so owned, all classes of stock of the corporation are aggre-

gated; it is not necessary that 80 percent of the value of shares of each class be so owned.

Subparagraph (B) of section 1563(a)(1) provides that the common parent corporation must own (within the meaning of sec. 1563(d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations in the group, excluding for purposes of computing such voting power or value any stock owned directly by other corporations in the group.

The definition of a parent-subsidiary controlled group of corporations contained in section 1563(a)(1) is illustrated by the following examples:

Example (1).—Corporation P owns 80 percent of the total combined voting power of all classes of stock entitled to vote of corporation S. Corporation S, in turn, owns 80 percent of the total value of shares of all classes of stock of corporation S–1. Corporation P is the common parent corporation of a parent-subsidiary controlled group of corporations consisting of member corporations P, S, and S–1.

Example (2).—Corporation P owns 75 percent of the total combined voting power of all classes of stock entitled to vote of corporations S and S–1; S owns all the remaining voting stock of S–1; and S–1 owns all the remaining voting stock of S. Since intercompany stockholdings are excluded for purposes of determining whether corporation P owns at least 80 percent of the voting power of at least one of the other corporations, P is treated as the owner of 100 percent of the voting power of either S or S–1 for purposes of section 1563(a)(1)(B). Also, 100 percent of the voting power of S and S–1 is owned by the other corporations in the group within the meaning of section 1563 (a)(1)(A) (P and S–1 together own 100 percent of the voting power of S, and P and S together own 100 percent of the voting power of S–1). Therefore, corporation P is the common parent corporation of a parent-subsidiary controlled group of corporations consisting of member corporations P, S, and S–1.

Brother-sister controlled group

Paragraph (2) of section 1563(a) defines a brother-sister controlled group of corporations as two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of sec. 1563(d)(2)) by one person who is an individual, estate, or trust. For example, individual A owns 80 percent of the total combined voting power of all classes of stock entitled to vote of corporations X and Y. Corporations X and Y are members of a brother-sister controlled group of corporations as defined in section 1563(a)(2).

Combined group

Paragraph (3) of section 1563(a) defines a combined group as a separate controlled group of corporations consisting of three or more corporations if—

(1) each corporation is a member of either a parent-subsidiary controlled group of corporations (as defined in sec. 1563(a)(1)) or

a brother-sister controlled group of corporations (as defined in sec. 1563(a)(2)), and

(2) at least one of the corporations is a common parent corporation included in a parent-subsidiary controlled group of corporations and also is included in a brother-sister controlled group of corporations.

The definition of a combined group of corporations contained in section 1563(a)(3) is illustrated by the following examples:

Example (1).—Individual A owns 80 percent of the total combined voting power of all classes of the stock of corporations B and P. Corporation P, in turn, owns all the stock of corporation S. Since—

(1) corporations B, P, and S are each members of either a parent-subsidiary or brother-sister controlled group of corporations, and

(2) corporation P is a common parent corporation included in a parent-subsidiary controlled group of corporations (consisting of member corporations P and S) and also is a member of a brother-sister controlled group of corporations (consisting of member corporations P and B),

corporations P, B, and S are members of a combined group of corporations within the meaning of section 1563(a)(3).

Example (2).—Assume the same facts as in example (1), except that corporation B owns all the stock of corporation T. Corporations P, B, S, and T are members of a combined group of corporations within the meaning of section 1563(a)(3).

Certain insurance companies

Paragraph (4) of section 1563(a) provides that two or more life insurance companies subject to taxation under section 802 of the code which are members of a controlled group of corporations described in paragraph (1), (2), or (3) of section 1563(a) are, for purposes of the new part II, considered as a controlled group of corporations consisting of only such insurance companies. Corporations which are not life insurance companies, but which would be members of the same controlled group of corporations as the life insurance companies were it not for the application of paragraph (4), are treated as members of a separate controlled group of corporations.

The definition of a controlled group of insurance companies contained in section 1563(a)(4) is illustrated by the following example:

Corporation P owns all the stock of corporation I which, in turn, owns all the stock of corporation X. Also, corporation P owns all the stock of corporation Y which, in turn, owns all the stock of corporation J. Corporations I and J are life insurance companies taxable under section 802 of the code. Since corporations I and J are members of a parent-subsidiary controlled group of corporations described in section 1563(a)(1), such companies are treated as members of a controlled group of corporations separate from corporations P, X, and Y for the purposes of new part II. Also, corporations P, X, and Y are treated as members of a parent-subsidiary controlled group of corporations separate from the group consisting of corporations I and J.

(*b*) *Component member.*—Section 1563(b) provides the rules for determining whether a corporation is a component member of a controlled group of corporations. The term "component member"

is used throughout the new part II. For example, section 1561, which reduces the surtax exemption of certain corporations, affects only a corporation which is a component member of a controlled group of corporations. Also, under section 1562, only a corporation which is a component member of a controlled group of corporations is required to pay the additional tax imposed by section 1562(b).

General rule

Paragraph (1) of section 1563(b) states the general rule that a corporation is a component member of a controlled group of corporations on a December 31 (and with respect to the taxable year of such corporation which includes such December 31) if such corporation—

(A) is a member of a controlled group of corporations (as defined in sec. 1563(a)) on the December 31 included in such year and is not, for such year, treated as an "excluded member" under section 1563(b)(2), or

(B) is not a member of such controlled group of corporations on the December 31 included in such year but is, for such year, treated as an "additional member" of such group under section 1563(b)(3).

Excluded members

Paragraph (2) of section 1563(b) provides that a corporation which is a member of a controlled group of corporations (within the meaning of sec. 1563(a)) on any December 31 is treated as an excluded member of such group for its taxable year which includes such December 31 if any one of subparagraphs (A) through (E) of section 1563(b)(2) is applicable.

Under subparagraph (A) of section 1563(b)(2), a corporation is treated as an excluded member if it has been a member of the group for less than one-half the number of days in its taxable year which precede the December 31 included within such taxable year.

Under subparagraph (B) of section 1563(b)(2), a corporation is treated as an excluded member if it is exempt from taxation under section 501(a) of the code (except a corporation which has unrelated business taxable income subject to tax under sec. 511) for such taxable year.

Under subparagraph (C) of section 1563(b)(2), a corporation is treated as an excluded member if it is a foreign corporation subject to tax under section 881 of the code for such taxable year. Thus, a foreign corporation not engaged in trade or business in the United States is not treated as a component member.

Under subparagraph (D) of section 1563(b)(2), a corporation is treated as an excluded member if it is an insurance company subject to taxation under section 802 or 821 of the code for such taxable year. If a life insurance company taxable under section 802 is a member of a controlled group of insurance companies described in section 1563(a)(4), it is not treated as an excluded member of the life insurance company group of which it is a member. However, in such a case, the life insurance company is treated as an excluded member of a controlled group of corporations described in section 1563(a) (1), (2), or (3) of which it is a member. Thus, for example, if corporation P owns all the stock of corporations X, L_1, and L_2 (L_1 and L_2 being life insurance companies taxable under sec. 802) corporations L_1 and L_2 are treated as excluded members of the parent-sub-

sidiary controlled group of corporations consisting of P, X, L_1, and L_2, but are not treated as excluded members of the controlled group of insurance companies consisting of L_1 and L_2.

Under subparagraph (E) of section 1563(b)(2), a franchised corporation defined in section 1563(f)(4) is treated as an excluded member. (See the discussion in this report of franchised corporations under sec. 1563(f)(4).)

Additional members

Paragraph (3) of section 1563(b) provides that a corporation which—

> (1) was a member of a controlled group of corporations at any time during a calendar year;
>
> (2) is not a member of such group on December 31 of such calendar year; and
>
> (3) is not described, with respect to such group, in paragraph (2) (B), (C), (D), or (E) of section 1563(b),

is treated as an additional member of such group for the corporation's taxable year which includes such December 31 if the corporation was a member of the group (within the meaning of sec. 1563(a)) for one-half (or more) of the number of days in such taxable year which precede such December 31.

The provisions of section 1563(b) (1), (2), and (3) are illustrated by the following examples:

Example (1).—Individual A owns all the stock of corporations W and X on each day of 1964. Corporation W and corporation X each uses the calendar year as its taxable year. On January 1, 1964, A also owned all the stock of corporation Y (a fiscal year corporation with a taxable year beginning on July 1, 1964, and ending on June 30, 1965) which he sells on October 15, 1964. On December 1, 1964, A purchases all the stock of corporation Z (a fiscal year corporation with a taxable year beginning on September 1, 1964, and ending on August 31, 1965). On December 31, 1964, individual A is the common owner of a brother-sister controlled group of corporations within the meaning of section 1563(a)(2) consisting of member corporations W, X, and Z. However, the component members of the group on such December 31, within the meaning of section 1563(b), are corporations W, X, and Y. Under subparagraph (A) of section 1563(b)(2), corporation Z is treated as an excluded member of this group since Z was a member of the group less than one-half of the number of days (29 out of 121 days) in the period September 1 (the first day of its taxable year) to (but not including) December 31, 1964. Under section 1563(b)(3), corporation Y is treated as an additional member since Y was a member of the group one-half or more of the number of days (107 out of 183 days) in the period July 1 (the first day of its taxable year) to (but not including) December 31, 1964.

Example (2).—On January 1, 1964, corporation P owns all the stock of corporation S–1, which in turn owns all the stock of corporation S–2. Also, on January 1, 1964, corporation X owns all the stock of corporation Y. On November 1, 1964, corporation P purchases all of the stock of corporation X and sells all of the stock of corporation S–1 to the public. Corporations P, S–1, S–2, X, and Y file their returns on the basis of the calendar year. On December 31, 1964, corporations P, X, and Y are members of a parent-subsidiary controlled group of

corporations (within the meaning of sec. 1563(a)(1)); also, corporations S–1 and S–2 are members of a separate parent-subsidiary controlled group on such date. However, since corporations X and Y have been members of the parent-subsidiary controlled group of which corporation P is the common parent for less than one-half the number of days in the period January 1 through December 30, 1964, they are not component members of such group on such date. On the other hand, corporations X and Y have been members of a parent-subsidiary controlled group (consisting of member corporations X and Y) for one-half (or more) of the number of days in the period January 1 through December 30, 1964, and therefore they are component members of such group on such date. Also, since corporations S–1 and S–2 were members of the parent-subsidiary controlled group of which corporation P is the common parent for one-half (or more) of the number of days in the taxable years of each such corporation in the period January 1 through December 30, 1964, P, S–1, and S–2 are component members of such group on December 31, 1964.

Example (3).—Throughout calendar year 1964, corporation P owns all the stock of corporation F which, in turn, owns all the stock of corporations X and I. Corporation F is a foreign corporation subject to tax under section 881 of the code on its U.S. source income, corporation I is a life insurance company subject to tax under section 802 of the code, and corporations P and X are domestic corporations subject to tax under section 11 of the code. Each corporation files its returns on the basis of the calendar year. On December 31, 1964, corporations P, F, X, and I are members of a parent-subsidiary controlled group of corporations as defined in section 1563(a)(1). However, corporations F and I are not component members of such group because they are excluded members within the meaning of section 1563(b)(2) (C) and (D). Thus, on December 31, 1964, the component members of the parent-subsidiary controlled group of which corporation P is the common parent are corporations P and X.

Example (4).—Corporation P owns all the stock of corporation S from January 1, 1964, through September 1, 1964. Each corporation files its returns on the calendar year basis. On September 2, 1964, corporation P sells its stock in corporation S to the public. The additional member rule contained in section 1563(b)(3) results in corporation P and corporation S being treated as component members of a parent-subsidiary controlled group of corporations consisting of corporations P and S on December 31, 1964.

Overlapping groups

Paragraph (4) of section 1563(b) provides that if a corporation is a component member (within the meaning of sec. 1563(b)(1)) of more than one controlled group of corporations with respect to any taxable year, such corporation is treated as a component member of only one controlled group.

The determination as to the group of which a corporation described in paragraph (4) is a component member for purposes of applying the rules contained in the new part II is to be made under regulations prescribed by the Secretary of the Treasury or his delegate which are consistent with the purposes of the new part II. The regulatory provisions issued pursuant to the authority granted to the Secretary

of the Treasury or his delegate under paragraph (4) could appropriately provide that—

(1) in any case where 80 percent or more of the total value of shares of all classes of stock of a corporation is owned by a common owner of a brother-sister controlled group (or by a member, or members, of a parent-subsidiary controlled group of corporations) and 80 percent or more of the total combined voting power of all classes of stock of the corporation entitled to vote is owned by a different common owner (or by a member, or members, of a different parent-subsidiary controlled group of corporations), such corporation will be assigned to the controlled group with respect to which 80 percent or more of the total value of its shares is owned; and

(2) in any case in which a corporation is a component member of one controlled group of corporations as a result of its stock being owned directly by a common owner (or by a member, or members, of a parent-subsidiary controlled group of corporations) and such corporation is also a component member of another controlled group of corporations as a result of its stock being owned constructively (within the meaning of sec. 1563(e)) by a different common owner (or by a member, or members, of a different parent-subsidiary group of corporations), such corporation will be assigned to the controlled group with respect to which its shares are directly owned.

(*c*) *Certain stock excluded.*—Paragraph (1) of section 1563(c) provides that for purposes of the new part II the term "stock" does not include—

(A) nonvoting stock which is limited and preferred as to dividends,

(B) treasury stock, and

(C) stock which is treated as "excluded stock" under section 1563(c)(2).

Stock treated as "excluded stock"

Paragraph (2) of section 1563(c) provides that for purposes of determining whether the requisite stock ownership exists so as to make a corporation a member of a controlled group of corporations described in section 1563(a), any stock in the corporation held by certain shareholders is to be treated as if it were not part of the corporation's capital structure.

Subparagraph (A) of section 1563(c)(2) specifies the stock which is treated as excluded stock for purposes of applying the stock ownership tests contained in the definition of parent-subsidiary controlled groups of corporations (sec. 1563(a)(1)). Subparagraph (B) contains similar provisions with respect to brother-sister controlled groups of corporations (sec. 1563(a)(2)). The rules contained in subparagraphs (A) and (B) of section 1563(c)(2) are also applicable for purposes of determining whether a combined group (as defined in sec. 1563(a)(3)) or a controlled group of insurance companies (as defined in sec. 1563(a)(4)) exists.

Parent-subsidiary controlled group

Subparagraph (A) of section 1563(c)(2) specifies the stock which is excluded for purposes of determining whether a corporation (re-

ferred to herein as a "subsidiary corporation") is a member of a parent-subsidiary controlled group of corporations within the meaning of section 1563(a)(1). A condition precedent to the treatment of any stock as excluded stock is that 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in the subsidiary corporation must be owned (within the meaning of sec. 1563(d)(1) and after applying the constructive ownership rule contained in sec. 1563(e)(4)) by another corporation (referred to herein as the "parent corporation"). For purposes of determining whether the parent corporation owns the requisite 50 percent of stock in the subsidiary corporation, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, or treasury stock. (See sec. 1563(c)(1).)

Subparagraph (A)(i) specifies as excluded stock any stock in a subsidiary corporation held by a trust which is part of a plan of deferred compensation for the benefit of employees of the parent corporation or of the subsidiary corporation. A trust forming part of a stock bonus, pension, or profit-sharing plan (whether or not the plan is one described in sec. 401 of the code, and whether or not the trust is exempt from tax under sec. 501(a) of the code) is an example of a deferred compensation plan. The term "employee" is defined in section 1563(f)(1) (by reference to the definition of "employee" in sec. 3306(i) of the code).

Subparagraph (A) (ii) specifies as excluded stock any stock in a subsidiary corporation owned by an individual who is a principal stockholder or officer of the parent corporation. Ownership of stock by the individual is determined under section 1563(d)(2) (except that stock owned by the parent corporation is not excluded stock even though it is constructively owned by the individual by virtue of sec. 1563(e)(4)). The term "principal stockholder" of a corporation is defined by subparagraph (A)(ii) to mean an individual who owns (within the meaning of sec. 1563(d)(2)) 5 percent or more of the total combined voting power of all classes of stock entitled to vote or 5 percent or more of the total value of shares of all classes of stock in the corporation.

Subparagraph (A)(iii) specifies as excluded stock any stock in a subsidiary corporation which is owned (within the meaning of sec. 1563(d)(2)) by an employee of the subsidiary corporation if such stock is subject to conditions which run in favor of the parent corporation or subsidiary corporation and which substantially restrict or limit the employee's right (or, if the employee constructively owns such stock, the direct owner's right) to dispose of the stock. As used in subparagraph (A)(iii),the term "employee" includes an officer of the corporation (see sec. 1563(f)(1) for the definition of "employee" for purposes of sec. 1563). An example of a condition which substantially restricts or limits an employee's right to dispose of his stock within the meaning of subparagraph (A)(iii) is a condition whereby the parent corporation is given a right of first refusal if such stock is offered for sale.

The provisions of subparagraph (A) of section 1563(c)(2) are illustrated by the following examples:

Example (1).—Corporation P owns 70 of the 100 shares of the only class of stock of corporation S. The remaining shares of corporation S are owned as follows: 4 shares by individual A (the president of

corporation P), and 26 shares by individual B (who owns directly 10 percent of the voting stock of corporation P). Corporation P meets the 50-percent stock ownership requirement which is a condition precedent to the treatment of any stock as excluded stock under subparagraph (A) of section 1563(c)(2). Since individual A is an officer of corporation P, and individual B is a principal stockholder of corporation P, the stock owned by A in corporation S (4 shares) and the stock owned by B in corporation S (26 shares) is treated as excluded stock under subparagraph (A)(ii) of section 1563(c)(2). Thus, the total outstanding stock in corporation S is considered to consist of 70 shares, all of which are owned by corporation P. Therefore, corporations P and S are members of a parent-subsidiary controlled group of corporations.

Example (2).—Corporation P owns 60 percent of the only class of stock of corporation S. Individual E, the general manager of corporation S, owns the remaining 40 percent of the stock of corporation S. Individual E has agreed that if he offers his stock in S for sale he will first offer the stock to corporation P at a price equal to the then fair market value of the stock. Since the stock in S held by E is subject to conditions which run in favor of the parent corporation and substantially restrict E's right to dispose of such stock, such stock is treated as excluded stock under subparagraph (A)(iii) of section 1563(c)(2), and P is treated as owning 100 percent of the stock of S. Therefore, corporation P is the common parent of a parent-subsidiary controlled group of corporations consisting of member corporations P and S.

Brother-sister controlled group

Subparagraph (B) of section 1563(c)(2) specifies the stock of a corporation which is excluded for purposes of determining whether such corporation is a member of a brother-sister controlled group of corporations within the meaning of section 1563(a)(2). A condition precedent to the treatment of any stock of a corporation as "excluded stock" is that 50 percent or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 50 percent or more of the total value of shares of all classes of stock in the corporation must be owned (within the meaning of sec. 1563(d)(2)) by a person who is an individual, estate, or trust (hereinafter referred to as the "common owner"). For purposes of determining whether the common owner owns the requisite 50 percent of stock in a corporation, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, or treasury stock. (See sec. 1563(c)(1).)

Subparagraph (B)(i) specifies as excluded stock any stock in a corporation held by an employees' trust described in section 401(a) of the code which is exempt from tax under section 501(a) of the code and which is for the benefit of the employees of such corporation.

Subparagraph (B)(ii) specifies as excluded stock any stock in a corporation which is owned (within the meaning of sec. 1563(d)(2)) by an employee of such corporation subject to certain conditions which run in favor of the common owner or the corporation and which substantially restrict or limit the employee's right (or, if the employee constructively owns the stock, the right of the person who directly owns the stock) to dispose of the stock. However, if a condition

which limits or restricts an employee's right (or the direct owner's right) to dispose of his stock in a corporation is also applicable to stock in such corporation held by the common owner pursuant to a bona fide reciprocal stock purchase arrangement, such condition is not treated as one which restricts or limits the employee's right to dispose of such stock. For example, if two stockholders of a corporation, both of whom are employees, enter into a "buy-sell agreement" which provides that the stockholder-employees may not sell their stock interest to outsiders without first offering it to the other stockholder-employee (or the corporation) at a determinable price, such condition would not be treated as one which restricts or limits the employee's right to dispose of the stock.

(*d*) *Rules for determining stock ownership.*—Paragraph (1) of section 1563(d) provides the rules of stock ownership used in determining whether a corporation is a member of a parent-subsidiary controlled group of corporations (within the meaning of sec. 1563(a)(1)). Paragraph (1) provides that stock owned by a corporation means the stock owned directly by such corporation and also any stock which such corporation has an option to acquire (within the meaning of sec. 1563(e)(1)). Paragraph (2) provides the stock ownership rules for purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations (within the meaning of sec. 1563(a)(2)). Under paragraph (2), stock owned by a person who is an individual, estate, or trust means the stock owned directly by such person and also any stock constructively owned with the application of section 1563(e). The rules contained in paragraphs (1) and (2) are also applicable for purposes of determining whether a combined group (within the meaning of sec. 1563(a)(3)) or a controlled group of insurance companies (as defined in sec. 1563(a)(4)) exists.

(*e*) *Constructive ownership.*—Section 1563(e) provides rules for determining constructive ownership of stock for purposes of the new part II. For these purposes, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, or treasury stock (see sec. 1563(c)(1)).

Options

Paragraph (1) of section 1563(e) provides that a person is considered as owning any outstanding stock of a corporation if he has an option to acquire such stock. For purposes of this paragraph, an option to acquire such an option (and each one of a series of such options) is considered as an option to acquire such stock.

Attribution from partnerships

Paragraph (2) of section 1563(e) provides for the attribution of stock owned, directly or indirectly, by or for a partnership to a partner in proportion to the partner's interest in the partnership. The proportionate interest of a partner is based on his interest in the profits or the capital of the partnership, whichever such interest is the greater. However, no stock owned by or for the partnership is attributed to a partner who does not have at least a 5-percent interest in either the capital or profits of the partnership.

Attribution from estates or trusts

Paragraph (3)(A) of section 1563(e) provides for the attribution of stock owned, directly or indirectly, by or for an estate or trust to the

beneficiaries of these entities. Attribution is determined on the basis of each beneficiary's actuarial interest in the stock so owned by an estate or trust (and not on the basis of the beneficiary's interest in the estate or trust). This rule applies with respect to a beneficiary without regard to whether his interest is present or future, and without regard to whether his interest is vested or contingent. In applying this rule, the actuarial interest of each beneficiary in stock is determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary. However, there is no attribution of stock from an estate or trust to a beneficiary who has less than a 5-percent actuarial interest in such stock.

Paragraph (3)(B) of section 1563(e) provides a special rule in the case of certain trusts. Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J of chapter 1 of the code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

Paragraph (3)(C) of section 1563(e) provides that there is no attribution of ownership of stock to beneficiaries from an employees' trust if the trust is described in section 401(a) of the code and is exempt from tax under section 501(a) of the code.

Attribution from corporations

Paragraph (4) of section 1563(e) provides that a person is considered as owning stock owned, directly or indirectly, by or for a corporation in proportion to the value of his stock interest in the corporation. However, there is no attribution to a person who owns less than 5 percent of the value of all the stock in such corporation. For purposes of determining whether a person owns 5 percent or more of the stock of a corporation, the stock in such corporation owned by such person within the meaning of section 1563(d)(1) (if the person is a corporation), or section 1563(d)(2) (if the person is an individual, estate, or trust), is taken into account.

Spouse

Paragraph (5) of section 1563(e) provides the general rule that an individual is considered as owning stock in a corporation owned, directly or indirectly, by or for his spouse. The term "spouse" does not include a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance. Paragraph (5) also contains an exception to the general rule of attribution between spouses. An individual is not considered as owning (on any day of the taxable year of a corporation) stock in such corporation owned, directly or indirectly, by or for his spouse, provided the following conditions are satisfied with respect to such taxable year:

(A) The individual does not, at any time during such taxable year, own directly any stock in such corporation;

(B) The individual is not a director or employee and does not participate in the managment of the corporation at any time during such taxable year:

(C) Not more than 50 percent of the corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) The stock in the corporation is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock and which run in favor of the individual or his children who have not attained the age of 21 years.

For purposes of paragraph (5), the term "employee" is defined in section 1563(f)(1), and "child" includes a legally adopted child.

Children, grandchildren, parents, and grandparents

Paragraph (6) of section 1563(e) provides the attribution rules with respect to lineal descendents and ancestors. Subparagraph (A) of section 1563(e)(6) provides that an individual is considered as owning stock owned, directly or indirectly, by or for his children who are under the age of 21 years. Conversely, an individual who has not attained the age of 21 years is considered as owning stock owned, directly or indirectly, by or for his parents.

Subparagraph (B) provides the rules for attribution in the case of adult children, as well as grandchildren (regardless of age). If an individual owns, within the meaning of section 1563(d)(2) but without regard to such subparagraph (B), more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock in a corporation, then such individual is also considered as owning any stock in such corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren, and children who have attained the age of 21 years. A legally adopted child is treated as if such child were a child by blood.

(*f*) *Other definitions and rules.*—Paragraph (1) of section 1563(f) defines the term "employee" for purposes of section 1563 to have the same meaning as such term has in section 3306(i) of the code (relating to definitions for purposes of the Federal Unemployment Tax Act).

Operating rules

Paragraph (2) of section 1563(f) contains operating rules for applying the constructive stock ownership provisions of section 1563(e).

Subparagraph (A) of section 1563(f)(2) provides that stock which is constructively owned by a person by reason of the constructive ownership provisions of section 1563(e) is considered as actually owned by such person for purposes of again applying such provisions. An exception, contained in subparagraph (B) of section 1563(f)(2), provides that stock constructively owned by an individual by reason of the application of paragraphs (5) or (6) of section 1563(e) (relating to attribution among certain members of the family) is not considered as owned by him for purposes of again applying such paragraphs in order to make another the constructive owner of such stock.

Special rules

Paragraph (3) of section 1563(f) contains two special rules for purposes of section 1563.

The first special rule is contained in subparagraph (A) of section 1563(f)(3). Under this rule, if stock may be considered as owned by a person under paragraph (1) of section 1563(e) (relating to attribution

through option to acquire stock) and under any other paragraph of section 1563(e), it is considered as owned by him under paragraph (1). For example, assume individual F has an option to purchase the stock of a corporation which is owned by his son, S, aged 17 years. In such case, the stock is considered as owned by F under paragraph (1) of section 1563(e) and paragraph (6)(A) of section 1563(e). Under the special rule contained in subparagraph (A) of section 1563(f)(3), F is considered as owning the stock under paragraph (1) of section 1563(e). Since F is considered as owning the stock under paragraph (1) of section 1563(e), such stock may be reattributed under the rules relating to family attribution without violating the rule contained in subparagraph (B) of section 1563(f)(2).

The second special rule is contained in subparagraph (B) of section 1563(f)(3). This rule provides that if stock may be considered as owned by two or more persons, such stock is considered as owned by the person whose ownership of the stock results in the corporation being a component member of a controlled group of corporations. For example, assume individual W owns all the stock of corporation X and the conditions described in subparagraphs (A) through (D) of section 1563(e)(5) are satisfied. Therefore, the stock of corporation X owned by W is not attributed to her husband, H. Also, assume that H and W each directly own 50 percent of the only class of stock of corporation Y. Thus, all of the stock of corporation Y may be considered as owned by either H or W as a result of applying the general rule of spouse attribution of section 1563(e)(5) (H owns directly 50 percent of the stock of Y and is considered as owning the 50 percent owned by W; conversely, W owns directly 50 percent of the stock of Y and is considered as owning the 50 percent owned by H). Applying the special rule contained in subparagraph (B) of section 1563(f)(3), W is considered to own H's stock in corporation Y since only if H's stock holdings are attributed to W will corporation Y be a component member of a brother-sister controlled group of corporations for purposes of the new part II.

If the application of the operating rule of subparagraph (B) results in a corporation being a component member of two (or more) controlled groups, the corporation is treated as a component member of only one such controlled group. The determination of the controlled group of which such corporation is treated as a component member is to be made under regulations prescribed by the Secretary of the Treasury or his delegate which are consistent with the purposes of the new part II.

Franchised corporation

Paragraph (4) of section 1563(f) provides that a corporation (referred to as a "franchised corporation") which is franchised to sell the products of another member (or the common owner) of a controlled group of corporations will be treated as an excluded member of such group (under sec. 1563(b)(2)) for its taxable year if all of the following conditions are met for one-half (or more) of the number of days in such year preceding the December 31 included in such year (or, if the taxable year does not include December 31, one-half (or more) of the number of days preceding the last day of such year):

(1) The parent corporation (as defined in sec. 1563(c)(2)(A)), or common owner (as defined in sec. 1563(c)(2)(B)), of such

franchised corporation is under a duty (arising out of a written agreement) to sell stock of such franchised corporation.

(2) The stock of the franchised corporation is to be sold to an employee (or employees) of such corporation pursuant to a bona fide plan designed to eliminate the stock ownership of the parent corporation or of the common owner in the franchised corporation. This requirement is satisfied whether the stock is to be sold to the employee (or employees) or is to be redeemed by the franchised corporation.

(3) The plan provides a reasonable selling price for the stock.

(4) The plan requires that a portion of the employee's share of the profits of the franchised corporation (whether received as compensation or as a dividend) be applied to the purchase of the stock held by the parent corporation or common owner. Such profits may also be applied to the purchase of notes, bonds, debentures, or other similar evidence of indebtedness of the franchised corporation held by the parent corporation or the common owner. This provision does not require that a percentage of every dollar of the profits received by the employee must be applied to the purchase of the stock (or the indebtedness). The requirements of this provision are met even though the employee's share of the profits will not be applied unless certain specified conditions (such as a requirement that the corporation earn a specified profit) are met, provided such conditions are reasonable.

(5) The employee (or employees) own directly more than 20 percent of the total value of shares of all classes of stock in the franchised corporation.

(6) More than 50 percent of the inventory of the franchised corporation is acquired from members of the controlled group, the common owner, or both.

SECTION 223. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS, ETC. (Continued)

(*b*) *Disallowance of surtax exemption and accumulated earnings credit.*—Subsection (b) of section 223 of the bill amends section 1551 of the code (relating to disallowance of surtax exemption and accumulated earnings credit) in several respects. Section 1551 of the code provides, in general, that if a corporation transfers all or part of its property (other than money) to a corporation which was created for the purpose of acquiring such property or was not actively engaged in business at the time of the acquisition, the transferee corporation is not permitted the $25,000 surtax exemption or the $100,000 accumulated earnings credit if after the transfer the transferor or its shareholders, or both, are in control of the transferee, unless the transferee establishes by the clear preponderance of the evidence that the securing of the surtax exemption or the accumulated earnings credit was not a major purpose of the transfer.

Section 1551 of the code, as amended by this section of the bill, provides that in the case of transfers of property after June 12, 1963, an

indirect (as well as a direct) transfer of property (other than money) by a transferor corporation to a transferee corporation is within the scope of the section. Also, the coverage of section 1551 is extended to include certain transfers of property to a corporation after June 12, 1963, by individuals if after the transfer certain stock ownership requirements are met. Finally, section 1551, as amended, provides that if a surtax exemption is disallowed to a corporation under such section for any taxable year, the additional tax imposed by section 1562(b) of the code (as added by sec. 223(a) of the bill) is not applicable to such corporation for such taxable year.

Section 1551(a)(1) as amended refers to a transfer by a corporation made on or after January 1, 1951, and on or before June 12, 1963. Such a transfer is governed by the provisions of existing law, since (under the effective date contained in sec. 223(d) of the bill) the amended section 1551 applies only to transfers made after June 12, 1963.

Under section 1551(a)(2) as amended, the direct or indirect transfer of property (other than money) after June 12, 1963, by a transferor corporation to a transferee corporation is a transfer of property subject to the provisions of section 1551, if after such transfer the transferor corporation is in control of the transferee corporation for any part of the latter's taxable year. An "indirect transfer" within the meaning of section 1551(a)(2) is illustrated by the following examples:

Example (1).—On June 15, 1963, corporation X organizes corporation Y (a wholly owned subsidiary) and transfers cash to such corporation which it then uses to purchase stock in trade from corporation X. The exception for transfers of money does not apply to the transfer by corporation X to corporation Y. X has made an indirect transfer of property (other than money) within the meaning of subsection (a)(2) of section 1551.

Example (2).—The stockholders of corporation X acquire property (other than money) of corporation X and as part of the same transaction transfer such property to corporation Y (a corporation which was created for the purpose of acquiring such property). The transfer of property to corporation Y by the stockholders of corporation X is an indirect transfer of property by corporation X.

Under section 1551(a)(3) as amended section 1551 is extended to include the direct or indirect transfer of property (other than money) to a transferee corporation after June 12, 1963, by five or fewer individuals who are in control of a corporation, if after such transfer such individuals are in control of the transferee corporation for any part of its taxable year. Control is defined for this purpose in section 1551(b)(2).

Section 1551(a) as amended provides that in the case of a transfer described in paragraph (2) or (3) thereof, if the transferee corporation was created for the purpose of acquiring the property involved or was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor or transferors are in control of the transferee corporation during any part of the taxable year of the transferee corporation, then for such taxable year of the transferee corporation the Secretary of the Treasury or his delegate may (except

as may be otherwise determined under sec. 1551(d)) disallow the surtax exemption (as defined in sec. 11(d) of the code), or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c) of the code, unless the transferee corporation establishes by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer.

Section 1551(b) as amended defines the term "control" for purposes of section 1551(a).

Paragraph (1) of section 1551(b) provides that the term "control" means, with respect to a transferee corporation described in section 1551(a)(2), the ownership by the transferor corporation, its shareholders, or both, of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock. This definition is substantially the same as the definition presently contained in section 1551 except that the new section 1563(e) of the code applies in determining the ownership of stock.

Paragraph (2) of section 1551(b) provides that five or fewer individuals are in control if such individuals own—

> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of (i) the transferee corporation, and (ii) at least one corporation which such individual (or individuals) controlled (within the meaning of sec. 1551(b)(2)(A), as amended) before the transfer, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each such corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.

For purposes of applying the stock ownership tests contained in section 1551(b) as amended, the constructive ownership rules of section 1563(e) of the code (as added by sec. 223(a) of the bill) apply.

The application of the definition of "control" contained in section 1551(b)(2), in the case of a transfer described in section 1551(a)(3), is illustrated by the following example:

Example.—On January 1, 1964, individual A owns 65 percent of the only class of stock of corporation X and individual B owns the remaining 35 percent of the stock. Also, on January 1, 1964, A and B transfer property (other than money) to corporation Y (a newly formed corporation) and receive stock of corporation Y in return. After the transfer, A and B own the stock of corporations X and Y in the following proportions:

	Corporation X	Corporation Y	Identical ownership
A	65	35	35
B	35	65	35
Total	100	100	70

The transfer of property by individuals A and B to corporation Y is a transfer described in section 1551(a)(3), as amended, since the same five or fewer individuals (A and B) own more than 80 percent of the stock of corporations X and Y as required under section 1551(b)(2)(A) and the identical ownership equals more than 50 percent as required under section 1551(b)(2)(B). The identical ownership of A and B is 70 percent, even though together they actually own 100 percent of the stock, since the stock taken into account for A is 35 percent and for B is 35 percent. Thus, the Secretary of the Treasury or his delegate may disallow the surtax exemption or the accumulated earnings credit to corporation Y, unless corporation Y establishes by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of the transfer of property to corporation Y.

Section 1551(c) as amended provides that if the surtax exemption is disallowed to a transferee corporation for any taxable year, the additional tax imposed under section 1562(b) of the code (as added by sec. 223(a) of the bill) is not applicable with respect to such transferee corporation for such taxable year.

Section 1551(d) as amended retains the provisions contained in the last sentence of the existing section 1551 relating to the application of the provisions of section 269(b) of the code.

(c) *Technical amendments.*—Paragraph (1) of section 223(c) of the bill makes a technical amendment to the second sentence of section 802(a)(1) of the code (relating to tax on life insurance companies).

Paragraph (2) of section 223(c) of the bill amends section 269(a) of the code (relating to acquisitions made to evade or avoid income tax) to make changes corresponding to the changes in the provisions of the new section 1551(c) (and the related provision of sec. 1551(a)) made by section 223(b) of the bill (see above).

Paragraph (3) of section 223(c) of the bill amends section 441(f)(2)(A) of the code (relating to effective date with respect to special rules for 52-53 week year). Under this amendment, if a corporation elects a 52-53 week taxable year under section 441(f)(1) of the code and such taxable year includes more than one December 31, the applicability of the new part II of subchapter B of chapter 6 of the code to such taxable year would be determined by applying the provisions of section 441(f)(2)(A). Accordingly, such year is treated as containing only one December 31, and such December 31 is applicable in applying the new part II.

Paragraph (4) of section 223(c) of the bill adds a table of parts and a heading to subchapter B of chapter 6 of the code.

(d) *Effective date.*—Subsection (d) of section 223 of the bill provides that the amendments made by subsections (a) and (c) of such section apply with respect to taxable years ending after December 31, 1963. The amendment by subsection (b) of such section applies with respect to transfers made after June 12, 1963.

TITLE III—OPTIONAL TAX ON INDIVIDUALS; COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SECTION 301. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000

(*a*) *Optional tax.*—Subsection (a) of section 301 of the bill amends section 3 of the code (relating to optional tax if adjusted gross income is less than $5,000). Under the existing provisions of section 3, there is imposed on the taxable income of each individual whose adjusted gross income is less than $5,000, and who has elected to pay the tax imposed by section 3, the tax shown in the table set out in section 3

Taxable years beginning in 1964

Section 3(a) of the code, as amended by this section of the bill, is applicable to taxable years beginning on or after January 1, 1964, and before January 1, 1965. It retains the substantive rules contained in the existing section 3 but substitutes for the table in the existing section 3 the following tables:

Table I—Single person, NOT head of household.
Table II—Head of household.
Table III—Married persons filing JOINT returns.
Table IV—Married persons filing SEPARATE returns, 10 PERCENT STANDARD DEDUCTION.
Table V—Married persons filing SEPARATE returns, MINIMUM STANDARD DEDUCTION.

Taxable years beginning after December 31, 1964

Section 3(b) as amended is applicable to taxable years beginning after December 31, 1964. Like the amended section 3(a), the amended section 3(b) retains the substantive rules of the existing section 3 but substitutes for the table in the existing section 3 tables with captions identical to the captions of the tables in the amended section 3(a).

(*b*) *Rules for optional tax.*—Subsection (b) of section 301 of the bill amends section 4 of the code (relating to rules for optional tax).

Husband or wife filing separate return

Paragraph (1) of section 301(b) of the bill amends section 4(c) of the code (relating to husband or wife filing separate returns). Under the provisions of the existing section 4(c), a husband or wife may not elect to pay the optional tax imposed by section 3 if the tax of the other spouse is determined under section 1 of the code on the basis of taxable income computed without regard to the standard deduction. This rule is retained in paragraph (1) of section 4(c) as amended. The existing section 4(c) also provides that, for purposes of such section, determination of marital status is to be made under section 143 of the code. This rule is retained in paragraph (4) of section 4(c) as amended.

Paragraph (2) of section 4(c) as amended provides that, except as otherwise provided in such section, in the case of a husband or wife filing a separate return and electing to pay the tax imposed by section 3, the tax shall be the lesser of the tax shown in the Table IV (married persons filing separate returns, 10 percent standard deduction) or the

Table V (married persons filing separate returns, minimum standard deduction) which is applicable for the taxable year.

Paragraph (3) of section 4(c) as amended provides that neither Table V of section 3(a) nor Table V of section 3(b) applies in the case of a married individual filing a separate return if the tax of his spouse is determined with regard to the 10-percent standard deduction. Thus, notwithstanding the rule of section 4(c)(2), a married individual filing a separate return and electing to pay the tax imposed by section 3 must use Table IV (10-percent standard deduction) if his spouse takes the 10-percent standard deduction (including the case where his spouse uses Table IV).

Paragraph (3) of section 4(c) also provides that a married individual may elect to pay the tax shown in Table V in lieu of the tax shown in Table IV if he is a person described in section 141(d)(2) of the code (relating to standard deduction). A person described in section 141 (d)(2) is a married individual who files a separate return, provided that the minimum standard deduction of such individual is less than his 10-percent standard deduction and provided that the minimum standard deduction of such individual's spouse is greater than such spouse's 10-percent standard deduction. The definitions of the terms "10-percent standard deduction" and "minimum standard deduction" are contained in sections 141(b) and 141(c), respectively.

Paragraph (3) of section 4(c) also provides that, for purposes of the code, an election under such paragraph is treated as an election made under section 141(d)(2). Thus, the rules applicable to elections under section 141(d)(2) which are provided in section 144 (relating to election of standard deduction), including the rules as to changes of election provided in section 144(b) and (c), are applicable to an election under section 4(c)(3).

Amendment of section 6014

Paragraph (2) of section 301(b) of the bill amends section 6014(a) of the code (relating to income tax return-tax not computed by taxpayer). Under the existing provisions of section 6014(a), an individual entitled to elect to pay the tax imposed by section 3 of the code may, in certain cases, elect not to show on his return the tax imposed by section 1. The existing section 6014(a) further provides that in such cases the Secretary of the Treasury or his delegate computes the tax imposed by section 3, but, in determining the amount of tax payable, certain credits are not allowable and the tax is computed without regard to the taxpayer's status as head of household or as a surviving spouse. Paragraph (2) of section 301(b) of the bill adds to section 6014(a) the rule that, in the case of a married taxpayer filing a separate return and claiming the benefits of section 6014(a), neither Table V in section 3(a) nor Table V in section 3(b) is applicable. Thus, a married taxpayer filing a separate return who elects under section 6014(a) not to compute his tax is not entitled to have his tax determined with regard to the minimum standard deduction.

Technical amendments

Paragraph (3)(A) of section 301(b) of the bill amends section 4(a) of the code (relating to rules for optional tax) to reflect the fact that section 3 of the code (relating to optional tax if adjusted gross income is less than $5,000), as amended by this section of the bill, contains a new series of tables showing the tax imposed by section 3.

Paragraph (3)(B) of section 301(b) of the bill amends section 4(f) of the code by adding a cross reference to section 6014(a) (relating to income tax return-tax not computed by taxpayer), calling attention to the nonapplicability of Table V in section 3(a) and Table V in section 3(b) in cases where a married taxpayer filing a separate return elects under section 6014(a) to have his tax computed by the Secretary of the Treasury or his delegate.

(c) *Effective date.*—Subsection (c) of section 301 of the bill provides that, except for purposes of section 21 of the code (relating to effect of changes in rates during a taxable year), the amendments made by section 301 apply to taxable years beginning after December 31, 1963.

SECTION 302. INCOME TAX COLLECTED AT SOURCE

(a) *Percentage method of withholding.*—Subsection (a) of section 302 of the bill amends section 3402(a) of the code (relating to income tax collected at source) to provide a 15-percent withholding rate in the case of wages paid during the calendar year 1964 and a 14-percent withholding rate in the case of wages paid after December 31, 1964.

(b) *Wage bracket withholding.*—Subsection (b) of section 302 of the bill amends section 3402(c)(1) of the code (relating to wage bracket withholding) by providing new withholding tables for wages paid during the calendar year 1964, and new tables for wages paid after December 31, 1964.

(c) *Withholding of tax on certain nonresident aliens.*—Subsection (c)(1) of section 302 of the bill amends section 1441(a) of the code (relating to withholding of tax on nonresident aliens) to provide a 15-percent withholding rate in the case of payments made during the calendar year 1964, and a 14-percent withholding rate in the case of payments made after December 31, 1964.

Subsection (c)(2) of section 302 of the bill amends section 1441(b) of the code (relating to income items) to refer to the new rates of 15 percent or 14 percent, as the case may be, provided by the amended section 1441(a).

(d) *Effective dates.*—Subsection (d) of section 302 of the bill provides that the amendments made by subsections (a) and (b) of such section apply with respect to remuneration paid after December 31, 1963, and that the amendment made by subsection (c) applies with respect to payments made after December 31, 1963.

SUPPLEMENTAL VIEWS OF

HONORABLE A. SYDNEY HERLONG, Jr., AND HONORABLE HOWARD H. BAKER

ON INDIVIDUAL TAX RATE REDUCTION

SUPPLEMENTAL VIEWS OF A. SYDNEY HERLONG, JR., AND HOWARD H. BAKER ON INDIVIDUAL TAX RATE REDUCTION

A nation will welcome and benefit from a reduction in a tax burden which still reflects wartime conditions. For this reason we have joined in sending to the House H.R. 8363, which reduces this burden by more than $9 billion for individuals and by more than $2 billion for corporations.

Our purpose in filing these further views is not to object to what the committee has done in approving income tax rate reduction, but rather to what it has not done. While the new individual rate schedule would bring the confiscatory top rate down from 91 to 70 percent, and reduce the burden on the lowest taxable incomes by 30 percent, it neglects the problem of rate graduation in between.

Rate graduation or progression has become a widely accepted part of our individual income tax rate structure. It is not practical to expect that graduation will be eliminated or that we will move to a proportional system of income taxation. We strongly believe, however, that within accepted bottom and top rates, there should be sensible and equitable reform of graduation. Committee hearings and executive sessions over the years have resulted in a clear record that the present system of graduation has no economic or scientific basis, but, like Topsy, "it just growed."

Although the new schedule in H.R. 8363 provides rate reduction in the lowest bracket of 30 percent and in the highest bracket of about 23 percent, the reductions in the middle income brackets are as little as 15 percent. The result is that the H.R. 8363 rate structure climbs more steeply than the present structure through the lower portion of the graduated scale, that is, up to the bracket of $20,000 to $22,000.

The present rate structure and the schedule contained in H.R. 8363, imposes—relative to income total and bracket size—the heaviest graduation through the middle brackets. The extent of graduation is best visualized by the number of percentage points by which the rates increase from bracket to bracket. The key to systematic reform of rate graduation is minimizing the percentage points between brackets as an individual progresses up the income scale through the middle brackets.

The following table shows for the first 10 graduated brackets, encompassing taxable income from $2,000 to $22,000, (1) the present rate schedule; (2) the H.R. 8363 rate schedule; (3) a schedule providing for full reform of graduation, that is, the minimum percentage points between brackets; and (4) a schedule providing for partial reform of graduation.

Taxable income brackets	Present rates (1)	H.R. 8363 rates (2)	Full reform of graduated rates (3)	Partial reform of graduated rates (4)	Percentage points between brackets			
					(1)	(2)	(3)	(4)
	Percent	*Percent*	*Percent*	*Percent*				
$2,000 to $4,000	22	19	18	19	----	----	----	----
$4,000 to $6,000	26	22	19	21	4	3	1	2
$6,000 to $8,000	30	25	20	23	4	3	1	2
$8,000 to $10,000	34	28	21	25	4	3	1	2
$10,000 to $12,000	38	32	22	27	4	4	1	2
$12,000 to $14,000	43	36	23	29	5	4	1	2
$14,000 to $16,000	47	39	24	31	4	3	1	2
$16,000 to $18,000	50	42	25	33	3	3	1	2
$18,000 to $20,000	53	45	26	35	3	3	1	2
$20,000 to $22,000	56	48	27	37	3	3	1	2

The rates under (1) could be called ideal at these income levels and those under (2) would make a start toward the ideal.

The table presents the rate schedules only for the first 10 graduated brackets because it is in these brackets that the income jumps are the smallest—$2,000. The H.R. 8363 rate schedule, like the existing schedule, contains rate jumps between these brackets that are as great or in some instances greater than those applying to much higher brackets where the income jumps are double and triple those in the lower portion of the graduated rate scale. How the rates in these 10 brackets fit into overall rate schedules is shown in a second table (app. A) of these views.

Taking the overall rate structure, the best indication of the intensity of graduation is the division of percentage points of graduation between the middle brackets and the higher brackets.

Under the present rate structure 36 out of 71 of the percentage points of graduation are reached at the taxable income bracket of $20,000 to $22,000.

Under the schedule in H.R. 8363, 35 out of 56 of the percentage points of graduation are reached at this level. In other words, H.R. 8363 increases from one-half to nearly two-thirds the concentration of percentage points of graduation up through the $20,000 to $22,000 bracket.

It is somewhat ironic perhaps that in present law and under H.R. 8363 1 and 2 percentage point jumps do exist in the higher and larger graduated brackets but not through the middle income brackets. We believe that the only kind of graduation which would be logical and equitable and make any economic sense would be one under which rate jumps of more than 1 or 2 percentage points would come at the top and not at the bottom or through the middle of the graduated scale.

The President, in submitting his 1963 tax program to the Congress, stated that adoption of a new rate structure along the lines recommended would "restore an idea that has helped make our country great—that a person who devotes his efforts to increasing his income, thereby adding to the Nation's income and wealth, should be able to retain a reasonable share of the results." There obviously are many different views as to what is a "reasonable share" of a person's income. We believe, however, that the American people accept the idea that those citizens who work harder, put in longer hours, and contribute more in any undertaking are entitled to higher rate of pay and income. The extreme graduation of our tax rate structure that is perpetuated

and even compounded in H.R. 8363 operates in reverse; namely, to penalize our most productive citizens. A good analogy of the way the extremes of rate graduation operate to penalize these citizens would be a business firm that cut salesmen's commissions every time the sales are increased.

There is no case in equity for the disproportionate taxation of any part of the income of people whose achievements in life are totally dependent upon their own efforts. The increasing rate of taxation as they make their way up the income ladder is repugnant to the universally accepted principle of extra compensation for extra effort. The graduated rates place a penalty on what is considered meritorious and deserving outside of the tax field.

The extra and increasing burden rate graduation placed on these productive citizens smothers incentives, severely limits the accumulation of new venture capital, discourages the venturesome use of such new capital as it is accumulated, and, in general, inhibits the starting of new businesses and the expansion of old. The burden of rate graduation also serves to dull the incentives of our Nation's junior executives, budding small businessmen, and professional people—a story which has been told to the committee many times by representatives of the U.S. Junior Chamber of Commerce. It is these young people that we must rely upon to provide the enterprising spirit, the long hours of hard work and the management skills needed if the economy is to provide enough jobs to get and keep unemployment down to a relatively low level through the years ahead. The savings of citizens in the middle income brackets have historically been a prime source of venture capital needed for the creation of new jobs and for a dynamically expanding economy. It is a historic fact of our "free" economy that when it is not artificially restrained by excessive tax rates, or by other means, there never is enough venture capital or total capital to meet all the opportunities for investment and growth.

There are a number of widely held myths surrounding our system of tax graduation. One of these is that graduation is an instrument for redistributing wealth. It is often forgotten that the tax is levied on income, not on wealth. Steep graduation is only a device to prevent the accumulation of wealth out of income. Those who have wealth or inherit it can keep it insofar as the income tax is concerned.

Another of these myths is that extreme rate graduation is necessary from a revenue standpoint. Under the existing rate structure only 15 percent of the total revenue comes from the graduated portion of the rate scale with 85 percent coming from the 20 percent rate applied to all taxable income. Under the H.R. 8363 schedule, graduation above the $2,000 bracket would produce 20 percent of the total revenue, and the four lowest rates applied to all taxable income would provide 80 percent. These figures explain why partial reform of rate graduation as illustrated in column 4 of the tables can be achieved at a revenue cost of only a little more than $1 billion greater than the revenue cost of the H.R. 8363 schedule, retaining the same starting rate of 14 percent. Full reform of graduation would cost slightly over $3 billion additional.

The Secretary of the Treasury, in presenting the administration's tax program, told the committee that its "primary objective is to release our economy from the shackles of an overly repressive income

tax rate structure so that it can move ahead to full capacity utilization of its human and physical resources and avoid the recurring recessions that have characterized the postwar years." More recently the President has stated that H.R. 8363 will, among other things, "provide much needed jobs for our economy" and "increase our rate of economic growth." While we agree the lower burden of taxes including the lowering of the top rate, provided in the H.R. 8363 schedule, will have beneficial economic results, we are confident that the objectives stated by the President would be much better assured for the long range if the committee had approved a rate schedule providing full, or even partial, reform of the graduated rate structure. We believe it unfortunate that enactment of H.R. 8363, as now written, would leave the upward sweep of graduation through the middle brackets as a problem for the future.

APPENDIX A

Taxable income bracket	Present rates (1)	H.R. 8363 rates (2)	Full reform of graduated rates (3)	Partial reform of graduated rates (4)	Percentage points between brackets (1)	(2)	(3)	(4)
	Percent	Percent	Percent	Percent				
0 to $2,000	20							
0 to $500		14	14	14				
$500 to $1,000		15	15	15		1	1	1
$1,000 to $1,500		16	16	16		1	1	1
$1,500 to $2,000		17	17	17		1	1	1
$2,000 to $4,000	22	19	18	19	2	2	1	2
$4,000 to $6,000	26	22	19	21	4	3	1	2
$6,000 to $8,000	30	25	20	23	4	3	1	2
$8,000 to $10,000	34	28	21	25	4	3	1	2
$10,000 to $12,000	38	32	22	27	4	4	1	2
$12,000 to $14,000	43	36	23	29	5	4	1	2
$14,000 to $16,000	47	39	24	31	4	3	1	2
$16,000 to $18,000	50	42	25	33	3	3	1	2
$18,000 to $20,000	53	45	26	35	3	3	1	2
$20,000 to $22,000	56	48	27	37	3	3	1	2
$22,000 to $26,000	59	50	29	39	3	2	2	2
$26,000 to $32,000	62	53	31	41	3	3	2	2
$32,000 to $38,000	65	55	33	43	3	2	2	2
$38,000 to $44,000	69	58	35	45	4	3	2	2
$44,000 to $50,000	72	60	37	47	3	2	2	2
$50,000 to $60,000	75	62	39	49	3	2	2	2
$60,000 to $70,000	78	64	41	51	3	2	2	2
$70,000 to $80,000	81	66	43	53	3	2	2	2
$80,000 to $90,000	84	68	45	55	3	2	2	2
$90,000 to $100,000	87	69	47	57	3	1	2	2
$100,000 to $150,000	89	70	51	61	2	1	4	4
$150,000 to $200,000	90		55	65	1		4	4
$200,000 and over	91			70	1			5
$200,000 to $300,000			59				4	
$300,000 to $400,000			64				5	
$400,000 and over			70				6	

A. SYDNEY HERLONG, Jr.
HOWARD H. BAKER.

COMMITTEE ON WAYS AND MEANS

SEPARATE VIEWS OF REPUBLICANS ON H.R. 8363

SEPTEMBER 13, 1963

SUBMITTED BY

Representatives

John W. Byrnes,
Thomas B. Curtis,
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SEPARATE VIEWS OF REPUBLICANS ON H.R. 8363

GENERAL STATEMENT

H.R. 8363 embarks upon a program of deliberate and planned deficits in the guise of tax reform. The undersigned members of the Ways and Means Committee are in favor of a reduction in both individual and corporate tax rates. However, we believe that a tax cut of more than $11 billion, with no hope of a balanced budget for the foreseeable future, is both morally and fiscally wrong.

From the outset, the Kennedy administration has sought vainly to convince the Congress and the people that the Nation should and could buy greater prosperity on borrowed money. In the President's tax message in January of this year, he said it would be "a grave mistake to require that any tax reduction today be offset by a corresponding cut in expenditures." While the administration has sought subsequently to allay the concern of the Congress with reassuring statements to the contrary, the administration's deeds speak louder than its words. The administration's fiscal posture is clearly predicated upon both large Federal expenditures and large tax cuts *to be paid for with borrowed money.*

When the Kennedy administration took over the budget was balanced for fiscal 1961. This was soon converted to a deficit of $3.8 billion. For fiscal 1962, the administration had a deficit of $6.4 billion. Then in fiscal 1963, the administration submitted a balanced budget. However, fiscal 1963 ended up with a deficit of $6.2 billion even after deducting some $2 billion of nonrecurring revenue from the sales of Government loans and other assets. For fiscal 1964, the administration forecasts a deficit of $9.2 billion, again after allowing for sales of Government assets at the same rate as during fiscal 1963. The trend of the administration is toward constantly increasing expenditures, and constantly increasing deficits. This is demonstrated by the following table:

TABLE 1.—*Comparative budget receipts and expenditures*

[In billions]

	Fiscal 1961 estimate [1]	Fiscal 1961 actual	Fiscal 1962 actual	Fiscal 1963 actual	Fiscal 1964 estimate [2]	Fiscal 1965 estimate [2]	Increase
Budget receipts	$79.0	$77.7	$81.4	$86.4	$88.8	$92.0	$13.0
Budget expenditures	78.9	81.5	[3] 87.8	[4] 92.6	[5] 98.0	102.0	23.1
Budget deficit	(0.1)	3.8	6.4	6.2	9.2	10.0	----------

[1] Contained in fiscal 1962 budget message, released Jan. 16, 1961.
[2] Secretary of the Treasury, during committee consideration of tax bill, assumes tax cut effective Jan. 1, 1964.
[3] Actual expenditure rate $89.2 billion, less sale of Government assets of $1.4 billion.
[4] Actual expenditure rate $94.5 billion, less sale of Government assets of $1.9 billion.
[5] Actual expenditure rate $99.8 billion, less sale of Government assets of $1.8 billion.

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By fiscal 1965, Federal expenditures under the Kennedy administration will have increased by some $23 billion. On the basis of the administration's own estimates, revenues will have increased by only $13 billion. The annual fiscal posture of the Government will have deteriorated in progressive stages from a proposed balanced budget to a $10 billion deficit. As the new proposed tax rates become effective we will only add to the deficit, and increase the public debt. Unless and until the administration by its deeds makes a sincere effort to reverse this trend, the undersigned Republican members of the committee believe that the risks inherent in reducing taxes outweigh any possible benefits.

Our opposition in this respect is shared by the Republican Members of the Joint Economic Committee, who held extensive hearings on the economic aspects of the Administration's fiscal program. In the report submitted by that committee, the Republicans state:

> The tax reduction program—coupled with the lack of restraint in spending which characterizes the administration and the Democratic Congress—would result in a series of large and prolonged budget deficits. These would create difficult problems of debt management, further increase the burden of interest payments on the public debt, probably lead to renewed inflationary pressures, and have an adverse effect on our persistent balance-of-payments and gold problems. Approval of the President's tax program should be contingent upon more vigorous steps to hold the line on expenditures, with the objective of bringing the budget into balance within the very near future.[1]

The basic issue presented by the tax bill does not involve the question whether tax reduction as such is desirable. Taxes should be levied only to meet Government expenditures. The level of Federal taxation must necessarily bear some relationship to such expenditures. Not only has the Administration failed to take action in order to "hold the line" on expenditures, but has continued to promote new and expanded Federal spending programs. There is even reason to believe that the Administration at the present time is busily engaged in devising new spending programs for fiscal 1965, an election year. Because of these conditions, we are unalterably opposed to the reduction of tax rates until there is a realistic control over expenditures.

DISCUSSION

REPUBLICANS FAVOR SOUND TAX REDUCTION

In opposing the enactment of this bill, the undersigned Republican members of the committee do not abandon the long-standing Republican position that the excessive tax burden, and steeply progressive tax rates, should be reduced. It is our position that such reductions can be made with constructive results only when the overall fiscal policy of the Government will justify them. In other words, tax reduction should be accompanied by a reduction, and not an increase, in the level of Government expenditures. This was the Republican position in 1947, and again in 1954, and it is our position today.

In 1947, the Truman administration anticipated a budget surplus of over $6 billion for fiscal 1948. The Republican majority in the Congress thereupon proposed a tax reduction of $3.8 billion, thereby reducing the expected budget surplus to between $2.3 and $3.8 billion.

[1] S. Rept. 78, 88th Cong., 1st Sess., p. 72 (1963).

In other words, of the budget surplus projected for fiscal 1948, the Republicans proposed to apply roughly 50 percent to the reduction of the public debt, then at $258 billion, and 50 percent to the reduction of the heavy wartime tax rates. Despite three successive vetos by President Truman, the bill became law as the Revenue Act of 1948. The act finally provided for a $7.1 billion tax reduction in fiscal 1949 and left an amount in excess of $7 billion for reduction of the public debt.

Again in 1954, the Eisenhower administration made a concentrated effort to reduce Government spending. This enabled the Republicans to reduce taxes by $7.4 billion, $4.6 billion of which went directly to individuals. Expenditures were simultaneously reduced from a level of $74.1 billion in fiscal 1953 to $64.4 billion in 1955. This remarkable reduction of $9.7 billion in the level of Government spending made possible the largest tax reduction in any single year in the history of our country. The 1954 tax reduction was followed by budget surpluses for fiscal 1956 and 1957.

In contrast with the fiscal policy of the Republican's tax reduction programs, the Kennedy Administration proposes tax reduction of $11 billion in the face of a $9 billion deficit, and planned increases in expenditures of at least $3 billion, and more likely $5 billion, per year thereafter. In commenting on this program, as contrasted with the policy of the Eisenhower administration, Dr. Raymond J. Saulnier, a former Chairman of the Council of Economic Advisers, said:

> The Eisenhower administration took a very firm stand against policies that would favor, or give any encouragement to, inflation. The Kennedy administration, on the other hand, * * * are prepared, themselves, to take substantial risks in fiscal matters. This is illustrated by their proposal to cut taxes heavily while expenditures are rising at a rapid rate. They want to do this at a time when we already have a substantial deficit in the federal budget and in our balance of international payments and when the economy is showing a good momentum. I can't conceive of General Eisenhower's administration proposing a policy of this type.[2]

The Democratic Party historically has advocated a policy of "tax and spend." Since the Democratic Congress enacted the first Income Tax Act in 1913, under a Democratic President, the Democrats have done little toward making tax reduction possible. Taxes have been increased on 14 separate occasions by a Democrat-controlled Congress, or House of Representatives, and a Democrat-controlled Ways and Means Committee. Only on one occasion during the past 50 years have the Democrats adopted a tax reduction program. On the other hand, the Republicans have reduced taxes on nine separate occasions, and were responsible for only one increase.

KENNEDY SPENDING INCOMPATIBLE WITH TAX REDUCTION

In proposing tax reduction at this time, the Kennedy administration seeks to preempt the historical position of the Republicans that the heavy burdens of excessive taxation should be reduced, while at the same time maintaining the traditional Democratic position with respect to public spending. The administration seeks to have its cake and eat it too. As Dr. Arthur F. Burns, professor of economics at Columbia University, also a former Chairman of the Council of

[2] Challenge: The Magazine of Economic Affairs, Institute of Economic Affairs, New York University, p. 18 (July 1963).

Economic Advisers, appearing before the Joint Economic Committee in the hearings on the 1963 Economic Report of the President, said:

> My purpose in going as far as I have is to emphasize the general conclusion to which the arithmetic inescapably points; namely, that unless the rising trend of Federal expenditures is halted or sharply curbed, the adoption of the recommended tax proposal is likely to involve our Nation in budget deficits over many years and on a very substantial scale. We are not dealing here with a proposal for a temporary deficit.
>
> If the Congress sanctions long-range budget deficits, it will be adopting a novel concept for our country. This concept marks a departure not only from the old-fashioned theory that the budget should be balanced every year, but also from the modern theory that the Federal budget should be balanced over a business cycle or over a few years.[3]

The Kennedy administration seeks to embrace both the spending philosophy of the New Deal and the tax philosophy of the Republicans. It is indeed a "novel concept." We believe that the two are incompatible. Tax reduction without spending reform not only is meaningless, but is fraught with grave dangers.

Even the so-called Business Committee for Tax Reduction in 1963, a group "fathered" by the Treasury Department, recognized the need for expenditure control. In explanation of its fiscal position, this Committee stated:

> As the Committee has said, control of our current and future expenditures is vital. Unless this is done, we will hurt, if not negate, the good results anticipated from the recommended tax cuts. This control is needed to restore the Nation's confidence in its own fiscal affairs, to reassure our foreign creditors, and to assist in solving our critical balance-of-payments problem.[4]

As contrasted with the attitude of the Kennedy administration with respect to expenditure control, the Tax Reduction Committee also agreed with the Republican position that the Federal budget for fiscal 1964 could and should be reduced, and that the budget for fiscal 1965 and 1966 should be maintained at the level of the fiscal 1964 budget. The Tax Reduction Committee stated:

> The committee believes that a reduction in the 1964 budget is reasonable and practicable. Furthermore, it believes that there is no situation foreseeable which would necessarily require the 1965 and 1966 budgets to increase over that proposed for 1964. We have had large, progressive increases in recent years, and there is no justification for a continuation of the upward trend.[5]

The Kennedy administration still plans Federal expenditures of $98 billion for fiscal 1964, and admittedly has no intention of maintaining future expenditures at the 1964 level. In fact, the Secretary

[3] Hearings on January 1963 Economic Report of the President before the Joint Economic Committee, 88th Cong., 1st sess., pt. 1, pp. 492–93 (1963).
[4] The Business Committee For Tax Reduction in 1963, Statement of Executive Committee (May 28, 1963).
[5] Ibid.

of the Treasury advised the committee that the administrative budget for fiscal 1965 would entail expenditures of about $102 billion, and that the administrative budget for fiscal 1966 would be at least $3 billion in excess of that amount, or would entail expenditures of at least $105 billion. Thus, the very conditions upon which the Tax Reduction Committee predicated its support for tax reduction do not exist and will not exist.

Adherence to the principles enunciated by the Tax Reduction Committee would require opposition to this legislation. As the Tax Reduction Committee pointed out, a tax cut of $11 billion, financed through additional Government borrowing, can be adopted only at the risk of loss of confidence in the dollar both at home and abroad. We agree. It is extremely foolhardy, and a cruel deception on the American people, to enact a tax cut of this magnitude so long as continuing pressures are being brought to bear by the administration for greater and greater spending.

TAX CUT ON BORROWED MONEY MORALLY WRONG

This bill provides for an ultimate tax cut of some $11 billion, and as a corollary, planned Federal deficits of $10 billion per year and upward for the foreseeable future. We are opposed to tax relief thus financed, not only out of concern for its economic effect, but because we believe it is morally wrong.

As Mr. Bernard Baruch, in testifying before the Senate Finance Committee, in April 1958, said:

> To reduce taxes with an unbalanced budget and so swollen a national debt is both uneconomic and immoral. * * * Before we ask the cook in the White House to bake us up a new inflationary pie, let us try to digest the inflation already loose in our system and to restore the value of earnings and savings.[6]

Tax reduction financed through additions to the public debt is contrary to the Puritan ethic of an overwhelming majority of the American people. They fully realize that it is morally wrong to mortgage the future earnings of their children and their grandchildren in order to enjoy presently the questionable luxury of grandiose spending and lower taxes.

In recognition of this "moral" concern, the Kennedy administration set about to "indoctrinate" the people in the New Frontier code of economic morality. This was to be a major educational effort. As much was freely acknowledged before the Joint Economic Committee, on January 28, 1963, by Dr. Walter W. Heller, Chairman of the Council of Economic Advisers, in a colloquy with Representative Martha W. Griffiths, of Michigan, as follows:

> Representative GRIFFITHS. Of course, it is very persuasive when I asked the question, "What would you do with a $100 reduction in taxes spread over a period of 12 months?" and I get a reply to a question I didn't ask, and 62 percent of all who reply was, "Don't cut the taxes." That is very persuasive.

[6] Hearings on Investigation of the Financial Condition of the United States, 85th Cong., 2d sess., pt. 5, pp. 1655–56 (1958).

> Mr. HELLER. Yes, that does indicate, and I think it well worth commenting on that part of your question, an enormous need for public education in the field of economics, economic policy, tax policy. * * * Major efforts have to be made along this line.[7]

Dr. Heller went on to say that "it is quite remarkable that the basic puritan ethic of the American people should be such that they want to deny themselves tax reduction * * * because of their fears of deficits, and the additions to the national debt." [8]

In an effort to overcome this "basic puritan ethic" and to allay these fears, the administration has sought to relate the national debt to private debt, or to the gross national product, or to population. The fact is that the national debt, which will have increased from a postwar low of $252.3 billion to $315.6 billion on June 30, 1964, will increase by at least another $10 billion each year thereafter if we endorse the fiscal policies of the Kennedy administration by the enactment of this bill. Interest charges alone on the public debt have doubled. Public debt is nonproductive, as compared with private debt. An interest burden of $10 billion annually is a heavy burden, irrespective of what relationship this might bear to other sectors of the economy. The increasing trend of the public debt, and the interest charges thereon, as shown in the table below, should be of concern to puritans and nonpuritans alike.

TABLE 2.—*Public debt increases and annual interest on public debt*

[In billions]

Fiscal year	Public debt at end of year	Annual interest on public debt [1]	Fiscal year	Public debt at end of year	Annual interest on public debt [1]	Fiscal year	Public debt at end of year	Annual interest on public debt [1]
1947	$258.3	$5.0	1953	$266.1	$6.5	1959	$284.7	$7.6
1948	252.3	5.2	1954	271.3	6.4	1960	286.3	9.2
1949	252.8	5.4	1955	274.4	6.4	1961	289.0	9.0
1950	257.4	5.7	1956	272.8	6.8	1962	298.2	9.1
1951	255.2	5.6	1957	270.5	7.2	1963	306.1	9.9
1952	259.1	5.9	1958	276.3	7.6	1964 est.	315.6	10.0

[1] Figures do not include interest on refunds of receipts or interest on uninvested trust funds which total somewhat under $100,000,000 depending on year.

Source: Fiscal 1964 Budget and prior budgets.

As of June 30, 1963, the Kennedy administration had already added $19.8 billion to the public debt, and now proposes a program of tax reduction coupled with increased expenditures *which will add at least another $50 billion to the debt, and with no plans of reducing or paying off these additions to the debt at any time.* Not only is this morally wrong, most of our States have laws making it a crime for an individual to incur bills which he does not intend to pay. It is a fraud.

By continuing to spend and borrow, and through tax reduction to avoid our responsibility to pay our bills, we will pass on to our children an unbearable burden of public debt. Repudiation may be the only course open to them. The ever-increasing public debt places in jeopardy the savings of the American people, their life insurance, and their expectations for pensions and old-age security. That is also why this tax-cut program is morally wrong.

[7] Hearings on January 1963 Economic Report, supra at 45.
[8] Ibid.

TAX CUT ON BORROWED MONEY FISCALLY WRONG—A "TIME BOMB" FOR INFLATION

In addition to the moral issue presented by this bill, there is also serious question whether a tax reduction of $11 billion, accompanied by planned deficits of $10 billion a year for the foreseeable future, is fiscally sound. Dr. Burns, when he appeared before the Joint Economic Committee, raised this question. He said:

> I believe that the danger of inflation and the risk of devaluation of the dollar are being understated these days. Let me mention only the fact that liquid assets held by the public have recently risen sharply. The increase was $25 billion in 1961 and $34 billion in 1962, in contrast to an average annual increase from 1955 to 1960 of only $13 billion.
>
> It takes time before an increase in the supply of money or of liquid assets has an effect on the price level, but if experience is any guide the effect will eventually be felt. * * * I seriously doubt if we could have a protracted and substantial increase of the Federal debt without exposing our currency, and with it our economy and international political prestige, to a very grave risk.
>
> Nor is inflation or its speculative anticipation the only danger of a policy of long-range deficits. A nation's mood can change suddenly. A series of large deficits in times when the economy is advancing may cause a revulsion of feeling and later paralyze the Government's ability to deal with a recession.[9]

The administration seeks to minimize the long-range fiscal danger in this bill. On the one hand the administration refers in its press releases to this tax cut of $11 billion as the largest in the history of our Nation. On the other hand, the administration states that notwithstanding an existing revenue gap of $8 to $10 billion, future Federal deficits will be reduced and the budget will ultimately be balanced by the "stimulative" economic effect of this bill. The administration claims that after the tax cut becomes fully effective, Federal revenues will increase at a steady rate of $6 billion per year while expenditure increases will be held to $3 billion per year. Thus, the deficit will be "narrowed" at the rate of $3 billion per year. Is this realistic? Obviously not. Even if so, at the rate of $3 billion per year it will be almost 4 years before the tax cut alone will be fully offset by increased revenues.

In the meanwhile, under the Kennedy administration expenditures have been increasing at the rate of $5.5 billion per year. Increases totaling $9.4 billion are scheduled for fiscal 1964 and fiscal 1965. Thereafter, according to a statement of the Secretary of the Treasury, the built-in increase in expenditures, which would take place even if the Congress enacted no new programs, amounts to $3 billion per year. Yet, as we well know, the Congress is being pressured daily by the administration to approve additional funds for programs such as foreign aid, Area Redevelopment Administration, Domestic Peace Corps, Youth Conservation Corps, urban mass transportation, accelerated public works, and general aid to education. The administra-

[9] Hearings on January 1963 Economic Report, supra at 493.

tion has been unrestrained in its demands for new and increased spending programs.

The assumption that budget receipts will increase at the rate of $6 billion per year is even more unrealistic. At no time in our past history have receipts shown a sustained growth from year to year. Table 3 shows the budget receipts and expendit· res since 1952. There is no consistent pattern which can be relied upon as a basis for projecting future receipts. Major increases in receipts never come "back to back."

TABLE 3.—*Administrative budget receipts and expenditures, 1952–63*

[In billions]

Fiscal year	Receipts		Expenditures	
	Actual	Increases from prior year	Actual	Increases from prior year
1952	$61.3		$65.3	
1953	64.7	$3.4	74.1	$8.8
1954	64.4	−.3	67.5	−6.6
1955	60.2	−4.2	64.4	−3.1
1956	67.9	7.7	66.2	1.8
1957	70.6	2.7	69.0	2.8
1958	68.6	−2.0	71.4	2.4
1959	67.9	−.7	80.3	8.9
1960	77.8	9.9	76.5	−3.8
1961	77.7	−.1	81.5	5.0
1962	81.4	3.7	[1] 87.8	6.3
1963	86.4	5.0	[2] 92.6	4.8

[1] Actual expenditure rate $89.2 billion, less sale of Government assets of $1.4 billion.
[2] Actual expenditure rate $94.5 billion, less sale of Government assets of $1.9 billion.
Source: 1952 through 1962, fiscal 1964 Budget; 1963, Secretary of the Treasury.

The so-called "multiplier" theory, which is relied upon by the administration to produce an increase of $6 billion per year in Federal tax revenues, is based upon a chain of assumptions. It is a "novel" economic theory, which cannot be tested against any demonstrable facts. The Department of Commerce freely acknowledged this before the Joint Economic Committee.[10] It completely ignores the psychological factors which in the final analysis, are the real motivators of a free economy. It is wholly unrealistic. A Republican member of the Joint Economic Committee pointed this out in his report as follows:

To make up the $10 billion net revenue loss involved in the President's tax reduction and reform proposal plus the current fiscal 1963 budget deficit of nearly $9 billion plus anticipated increases in Government expenditures (likely to run at least $5 billion a year under administration policies) would require an increase in gross national product on the order of $135 billion over the 3-year period to supply the tax revenue. Such an increase would mean an annual rate of growth in excess of 7 percent. In the last year our rate was slightly over 3 percent, so we can hardly expect a 7-percent rate to be achieved under this administration. It should be pointed out that even if the President's tax reduction stimulated an increase in rate to 5 percent, the annual deficit could well exceed $10 billion or more if the spending side of the budget is not brought under control. It is hard, cold figures like these, coupled with the Federal spending policies of the administration and the Democratically controlled Congress, which prompt the critical projections of Dr. Arthur Burns and Maurice Stans in the minority report.[11]

[10] Hearings on January 1963 Economic Report, supra at 247.
[11] S. Rept. 78, supra at 108.

There is no evidence of a real intention on the part of this administration to work toward a balanced budget either now, or at any date in the foreseeable future. The Chairman of the President's Council of Economic Advisers openly advocates deficit financing as the panacea for all of our economic, social, and political problems. He has not been repudiated by the administration, but only kept "under wraps" until the Congress votes on this bill.

The deficits which have been incurred by the Kennedy administration have not produced accelerated "economic growth." We do not believe that more and greater deficits will be any more productive. Even if we assumed that future increases in expenditures would not exceed increases in revenues, and based upon the past record of this administration this is highly unlikely, by the fiscal year 1969, when the administration claims the budget will be in balance, we will instead have added at least another $50 billion to the Federal debt.

Even our estimate of an increase of $50 billion in the public debt over the next few years is extremely optimistic. Dr. Arthur F. Burns, in his appearance before the Joint Economic Committee, projected that the public debt might increase by an additional $75 billion by fiscal 1972.[12] Mr. Maurice Stans, former Director of the Budget, foresaw possible deficits aggregating $100 to $150 billion.[13]

Regardless whether $50 billion, $75 billion, $100 billion, or $150 billion, it is indisputable that the bill increases the need for additional deficit financing at the very time when the financing of existing deficits presents a major problem. In financing this additional deficit, the Treasury may get money by the sale of obligations to the public. If this course is adopted, however, any stimulative effect of tax reduction will be offset by the increase in borrowing. On the other hand, if the Treasury finances the deficit through the banking system and the monetary authorities permit the supply of money and credit to rise, the effect will be the same as if the Treasury printed money to pay for the expenditures which taxes will no longer cover. Tax reduction financed by borrowing which increases the money supply must ultimately produce inflation. The fiscal program of the administration will superimpose additional deficits of $50 billion or more on a financial structure to which there will already have been added Kennedy deficits of $20 billion. This is a "time bomb" for inflation, not an incentive to sound economic growth.

TAX BILL FIRST STEP TO BIGGER DEFICITS

The Kennedy administration's tax program cannot be considered "in a vacuum." It is part of an overall fiscal policy of *planned deficits*. Dr. Heller explained this before the Joint Economic Committee, as follows:

> Senator PROXMIRE. What you are asking for, then, is an increased deficit rather than a tax cut, and it makes very little difference if we spend more or reduce taxes, but on the other hand, increased Government spending would provide a greater multiplier effect and, therefore, that would tend to balance the increase in incentives you would have?

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[12] Hearings on January 1963 Economic Report, supra at 492.
[13] S. Rept. 78, supra at 79.

Mr. HELLER. I would restate it this way: It isn't the deficit we seek. What we seek is an increase in the total demand in the economy, a removal, as it were, of the fiscal drag on spending in the economy. The President has pointed out——

Senator PROXMIRE. I understand that, but in order to achieve that, you say no matter whether we do it through the tax route or the spending route, we will have to achieve a bigger deficit in order to promote greater demand, stimulate the economy.

Mr. HELLER. Under current circumstances, the net effect is going to be the achievement of a bigger deficit, as you either increase spending or cut taxes. The choice between the two is made on the basis of whether you want to do your primary stimulating in spending through the private economy or through the public economy. The President has hoped in this $10 billion tax cut program, obviously, to do it through the private market economy.[14]

There is no assurance that continued deficits of the magnitude of $10 billion, whether planned or otherwise, will produce either accelerated economic growth or full employment. Suppose that the tax cut produced neither! Will the administration be prepared to abandon its philosophy of *planned* deficits?

We need only cite the experience of the area redevelopment program as an example of the administration's attitude. When the program proved to be a failure, the administration's reaction was to ask for more money. When annual deficits of $10 billion do not produce economic utopia, the administration will undoubtedly claim that the "plan" failed only because the deficits were not large enough. More and bigger deficits will be planned.

The danger of embarking on such a course should be obvious. It is self-destructive. The Russians will not "bury us," we will bury ourselves. A long-range program of "planned deficits" means a long-range program of planned inflation. Lord Keynes, from whom the Heller school of economics derived the concept of *planned* deficits, warned of the resulting danger. Keynes wrote:

> Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate *arbitrarily*; and while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between

[14] Hearings on January 1963 Economic Report, supra at 55.

> debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.
>
> Lenin was certainly right. There is no subtler, no surer means of overtunring the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.[15]

That is the real danger of embarking on a course of planned deficits. If the initial "dose" of inflation fails, larger doses will be required. Not even the New Frontier economists can guarantee that this bill will produce full employment, balanced budgets, and an end to our balance-of-payments deficits. Let us suppose, instead, that the economy experiences a recurring cyclical recession. Will the Congress then be called upon to further reduce taxes? What will be the resulting deficit? These are the questions which we face, and the risks, in embarking on a heretofore untried course of planned deficits. Responsible economists urge that we not take that risk.

DEMOCRATS SHARE CONCERN OVER SPENDING—COMMITTEE ACTION INEFFECTIVE

Our Democrat colleagues on the committee obviously share our concern over the future spending plans of the Kennedy Administration. Their puritan ethic was aroused. The Democrats wanted "to do something." Accordingly, the majority added to the bill "a hope and a prayer" that any future revenue increases would first be used "to eliminate the deficits in the administrative budget and then to reduce the public debt." The declaration, approved by the majority, further states: "To further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective."

In adopting the "sense of Congress" declaration, the majority recognized the need for taking some affirmative action to bring expenditures under control. The adoption of this declaration might salve the "nagging" conscience of fiscal responsibility for some Democrats. But, it will do little more, except possibly to defeat the very purpose for which it was intended. Their fears of future deficits may be allayed, but not rightfully so.

There should be no illusions regarding the fiscal policy of the administration. It is a policy of planned deficits to be brought about either through tax reduction or increased spending, or a combination of both. That was the Hobson's choice offered to the business community by President Kennedy this week. It rests upon the basic principles that planned deficits are desirable, regardless of the current state of the economy, as a means of promoting future economic growth. The Democrat members of the committee must either accept or reject that premise. The "sense of Congress" amendment does neither. It is wholly ineffective, because it does not meet the

[15] Keynes, John Maynard, "The Economic Consequences of the Peace," pp. 235–36 (New York: Harcourt, Brace and Howe, Inc., 1920).

issue. That is why the Republicans opposed the "sense of Congress" amendment.

An amendment was offered by the Republicans in committee whereby the second stage of the tax reduction scheduled to take effect January 1, 1965 would be forestalled if expenditures for the fiscal years 1964 and projected expenditures for the fiscal year 1965 were not maintained below the $98 billion level. This was not asking too much. It was $5.4 billion more than the expenditures for fiscal 1963. The amendment was narrowly rejected by the committee, undoubtedly as a result of extreme administration pressure.

If the majority is sincere in seeking the objectives as expressed in their declaration—and we do not intend to question that sincerity—they might better accomplish those objectives by supporting the Republican substitute. In fact, the only real objection that the Administration has advanced to the adoption of this substitute is that it might make uncertain the second stage of the tax cut. By this objection, the administration clearly indicates its unwillingness to have tax reduction *and* expenditure control. Otherwise, the administration could readily stay within the budgetary limitations proposed by the Republicans. This is the very reason why the Republicans feel that it is incumbent upon the Congress, if taxes are to be reduced, to ensure at the same time that budgetary deficits will not get completely out of hand.

KENNEDY EXPENDITURE LETTER MISLEADING

In recognition of the general concern of the public and the Congress over the administration's expenditure budgets, the President addressed a letter to the chairman of the Ways and Means Committee, dated August 19, 1963, in which the President stated that Federal expenditures will be limited "only to those which meet strict criteria of national need." The letter goes on to state that the President will submit a budget for fiscal 1965 involving an estimated deficit of less than $9.2 billion. *The letter is noticeably silent with respect to fiscal 1965 expenditures.*

As Shakespeare wrote "the lady doth protest too much." For, concurrently with these protestations of expenditure control, if a $9.2 billion deficit can be called such, the Secretary of the Treasury advised the committee that the administrative budget expenditures would amount to $98 billion for fiscal 1964 and that projected expenditures would amount to $102 billion for fiscal 1965. For fiscal 1965, the budget will have been increased $9.4 billion over 1963, or at a rate of almost $5 billion per year. The President can always hold the estimated 1965 deficit to less than $9.2 billion, just as he submitted a balanced budget for fiscal 1963, by overestimating revenues. The Congress should not be "taken in" again.

In the separate views of the Republicans on the bill to increase the public debt limit in the 2d session of the 87th Congress (H.R. 11990), we stated:

> The fiscal pattern of the Kennedy administration is clear. A balanced budget is submitted "on paper" to satisfy the advocates of fiscal responsibility, and to forestall, if possible, any further drain on the gold required to meet our foreign obligations. At the same time, the administration is pur-

suing a policy of increasing Federal expenditures, irrespective of the Federal revenues. That course satisfies that group of economists, including the White House "inner circle," who advocate public spending and Federal deficits as a means of insuring national prosperity.

There was thus submitted to the Congress for fiscal 1963 a Federal budget which was balanced through the simple expedient of forecasting Federal revenues sufficient to meet the desired level of Federal expenditures. Since that time, notwithstanding the failure of the economy to meet such expectations, the administration has stubbornly clung to the "myth" of a balanced budget.[16]

Once the appropriation requests had passed the Congress, and the 1962 congressional election was history, the administration felt it was no longer necessary to preserve the "fiction" of a balanced budget. The budget was revised. Revenues forecast for fiscal 1963 were reduced by $7.5 billion below the forecast submitted to the Congress in the President's budget message for fiscal 1963.

TABLE 4.—*Fiscal year 1963*

[In billions]

	Kennedy budget [1]	Revision [2]	Revision [3]	Revision [4]	Revision [5]	Actual	Change from beginning (+) or (−)
Budget receipts	$93.0	$93.0	$85.9	$85.5	$85.5	$86.4	−$6.6
Budget expenditures	92.5	93.0	93.7	94.3	94.3	92.6	+.1
Surplus (+) or deficit (−)	+0.5	0.0	−7.8	−8.8	−8.8	−6.2	−6.7
N.O.A	99.3	100+	102.2	103.2	103.2	101.2	+1.9
Public debt at end of year	295.2	294.0	(6)	303.5	305.3	306.1	+10.9

[1] Contained in fiscal 1963 budget message, released Jan. 18, 1962. Applicable on Mar. 13, 1962, when debt limit was increased from $298 to $300 billion.

[2] May 31, 1962—at this time limit increase from $300 to $308 billion to drop to $305, $300, and $285 billion was being considered (increase became effective July 1, 1962).

[3] Midyear review (Nov. 13, 1962)—released 1 week after 1962 congressional elections.

[4] Contained in fiscal 1964 budget message, released Jan. 17, 1963.

[5] May 1, 1963—at this time debt limit increased from $305 to $307 billion and then to $309 billion through Aug. 31, 1963, was being considered ($307 billion increase became effective May 29, 1963; $309 billion effective July 1, 1963.)

[6] Not given in midyear review.

Apparently, the administration is planning to resort to the type of financial manipulation for fiscal 1965 which characterized the budget for fiscal 1963. This should reassure no one.

KENNEDY CLAIMS OF EXPENDITURE REDUCTION A MIRAGE—SPENDING HAS NOT BEEN REDUCED

The Kennedy letter also claims that through the exercise of expenditure control the estimated Federal deficit for fiscal 1963 has been reduced from $8.8 billion to $6.2 billion, or a decrease of $2.6 billion. The administration can claim little credit for this improvement in the fiscal 1963 budget.

The so-called savings of $2.6 billion are attributable to several factors, none of which resulted from any positive action on the part of the administration to reduce spending.

[16] H. Rept. 1789, 87th Cong., 2d sess., pp. 15–16 (1962).

First, the administration proceeded to sell some $2 billion of disposable assets (principally loans held by the Government) in order to realize an additional $1 billion in excess of the January 1963 budget forecast. These additional sales occurred in the last few months of fiscal 1963, after the administration had been refused an increase in the debt limitation by the committee until the administration took positive action to improve its debt picture.

TABLE 5.—*Sales of assets, fiscal year 1963*

[In millions]

Budget accounts	Estimated in January budget	Actual	Amounts applied in reduction of expenditures
HHFA:			
Special assistance	$50	$294	$244
Management and liquidation	6	14	3
College housing	0	0	0
FHA purchase money	0	0	0
Public facilities	0	0	0
VA:			
Direct loan program	18	180	162
Loan guaranty program (vendee loans)	150	279	129
Export-Import Bank	60	336	276
FSLIC	3	3	0
SBA		8	8
Total (excluding Agriculture)	287	1,114	827
Agriculture (CCC certificates of interest)	639	[1] 823	184
Total	926	[1] 1,937	1,011

[1] Preliminary.

Source: Office of the Secretary of the Treasury, Office of Debt Analysis, June 24, 1963.

Second, tax revenues have increased by an estimated $0.9 billion over earlier forecasts because of an improvement in the economy. This improvement resulted from increased economic activity. Nothing was done by the Kennedy administration to bring about this increase.

Third, the improvement in the economy resulted in a $46 million reduction in claims for welfare. This was another factor which reduced budget expenditures—a factor over which the administration had no control. As the economy improved there was less need for welfare payments.

Fourth, in order to offset the unfavorable balance of payments, the Defense Department collected about $340 million in advance for military equipment sold overseas. This was used to offset other expenditures. While net defense expenditures were decreased by about $340 million on account of the advance collection, there was no change in the actual rate of spending.

Fifth, the so-called accelerated public works program was delayed because the States and local authorities were unable to initiate programs as rapidly as had been claimed by the administration. This does not reflect any real economy but merely an "involuntary" postponement of these expenditures.

In all, it is clear that the improvement of $2.6 billion in the fiscal 1963 budget cannot be ascribed to any change in attitude on the part of the administration with respect to spending. In fact, positive action taken by the administration to take advantage of a favorable

market for Government-held loans was brought about by reason of the urging of the Republican members of the committee, accompanied by the close vote in the House last May on the debt increase. The collection in advance of some $340 billion due for military equipment sold abroad was brought about by the pressure of an unfavorable balance-of-payments trend. Other "savings" were fortuitous, not intentional.

In addition, the administration claims credit for a decline in the rate of growth of civilian employment in the executive branch. What the administration really is saying is that new employees were not added as rapidly as had been contemplated. Employment in the executive branch on June 30, 1963, was still 5,000 above a year earlier. Moreover, employment in the executive branch has increased by 137,000 during the Kennedy administration and, according to the fiscal 1964 budget, executive branch employment is estimated to increase by another 36,000 during fiscal 1964.

At the same time that the President stated his intention to cut back expenditures, the administration was also urging committees of the Senate to restore cuts which had previously been made by the House of Representatives. In a recent vote, the House of Representatives cut back the foreign aid authorization bill (H.R. 7885) by some $585 million. This reduction reflected widespread belief that there was tremendous waste in our foreign aid expenditures. This action by the House provoked an intemperate attack by the President against those who voted for the cut. The President said the action was "a shortsighted, irresponsible, and dangerously partisan action. * * * The action of the House in drastically cutting the mutual security authorization bill is unprecedented, unwarranted, and unwise." [17]

Similarly, when the House voted down the bill (H.R. 4996) to increase the appropriation for the Area Redevelopment Agency by an additional $455 million, the President refused to accept that decision. The President said: "The tragic defeat of area redevelopment legislation could not have come at a worse time. * * * This program must not be allowed to die—and it is my intention to give the Congress another opportunity to support it." [18]

Any effort by Congress to exert restraints on spending meets with extreme counterpressures by the administration. In the face of this, it should be apparent that the administration has not and will not change its attitude with respect to planned deficits.

PLANNED DEFICITS NOT AN ECONOMIC PANACEA

The Kennedy administration states that the people should be prepared to set aside their "puritan ethic" not for personal gain, but for the good of the country as a whole. The New Frontier economists claim that the "planned deficits" which tax reduction will serve to insure for the future will cure the major economic failures of this administration. Tax reduction is offered as a cure to the persistent "hard core" unemployment at home and to the equally persistent balance-of-payments deficits which have destroyed confidence in the dollar abroad. In advancing tax reduction and greater deficits as the panacea for these economic problems, the administration ignores reality. It is purely wishful thinking.

[17] Press statement, Aug. 23, 1963.
[18] Press statement, June 13, 1963.

Our views in this respect are shared by many of our Democratic colleagues both in the House and in the Senate. After a full hearing on the economic effects of the administration's tax program, a Democratic member of the Joint Economic Committee made the following observation:

> Will deficits in fact stimulate sound long-term growth? Our recent history has plenty to say about the answer to this question.
>
> In the past 32 years this Nation has become thoroughly ex-experienced in Federal deficits. Deficits have been a continuous way of life for our National Government almost throughout this period. These deficits have been so immense that the national debt has exploded twentyfold since 1930: from $16 billion to over $300 billion.
>
> With this experience, this Nation should be expert on the stimulative effect of deficits on the economy. What has been the result?
>
> Except in World War II when deficits were astronomical, there is no evidence that continuous deficits have promoted economic growth. The evidence is all to the contrary.
>
> The biggest growth in peacetime Federal debt, for example, was in the decade of the thirties and in the period since 1957. The thirties period was characterized by disastrous economic stagnation and record unemployment, coinciding with 10 years of such heavy deficits that they would be equivalent to $20 billion annually today. From 1957 to date, Federal deficits have averaged a heavy $6 billion per year. And yet, economic growth has been the slow-moving despair of current economists during this very period.
>
> Advocates of the deficit route point to the impressive economic progress in Europe during the past decade to support the deficit stimulus theory. The economic situation in European countries during the past 10 years is so vastly different from ours—particularly in terms of demand—that the comparison is not a valid one.
>
> But even here what does the record show? The industrial star of Europe, Germany, enjoyed a mammoth 92-percent growth in industrial production in the 8 years between 1953 and 1961 (most recent year for which figures are available) compared to 20 percent in this country; but its deficit averaged 0.1 percent of GNP during this period compared to an average deficit of 0.4 percent of GNP in the United States. In terms of GNP, Germany had one-fourth the deficit and four times the growth of this country.[19]

The tax bill is intended to create more jobs through larger Federal deficits. For its stimulating effect the bill relies most heavily on increasing consumer spending. Admittedly, increased consumer spending will produce more "work." That does not mean that it will produce more "jobs." The basic problem is not a scarcity of jobs for skilled labor. The basic problem is to provide those seeking jobs with the needed skills. The most recent study shows that

[19] S. Rept. 78, supra at 33.

unemployment among males in the 25-to-54-age groups is 3.1 to 3.6 percent and among the skilled within those groups is reported to be less than 3 percent.

TABLE 6.—*Unemployment rate, by age and sex, July 1963*

Age and sex	*Percent unemployed*
Total	5. 7
Male	5. 1
14 to 19 years	15. 5
14 and 15 years	10. 0
16 to 19 years	17. 2
20 to 24 years	8. 3
25 to 34 years	3. 6
35 to 44 years	3. 1
45 to 54 years	3. 1
55 to 64 years	3. 7
65 years and over	3. 1
Female	7. 1
14 to 19 years	17. 7
14 and 15 years	10. 1
16 to 19 years	19. 3
20 to 24 years	9. 5
25 to 34 years	6. 9
35 to 44 years	4. 8
45 to 54 years	4. 4
55 to 64 years	3. 6
65 years and over	2. 5

Source: U.S. Department of Labor, Bureau of Labor Statistics, "Monthly Report on the Labor Force," p. 25 (August 1963).

As the above table clearly shows, unemployment is concentrated largely among males and females under 20 years of age, where skills are lacking. Increased consumer spending will mean more "work," or a longer workweek, for males in the 25-to-54 age groups. It cannot reduce the unemployment for the skilled much below 3 percent without creating severe pressure on the wage structure. It then becomes inflationary and only as such will have any impact on the unskilled group which presently constitutes the major unemployment problem. Job training and improvement of the mobility of labor are the proper solutions for the unemployment problem.

The committee originally incorporated in the proposed bill a provision for the deduction of moving expenses. While this provision only scratched the surface, it at least recognized that one of the major problems facing labor today is one of mobility. The rapid technological improvements which are taking place, and will be accelerated over the next few years, require a highly mobile labor force. Those who are "left behind" will be left jobless. A bill which purports to be directed towards the structural unemployment problem is highly deficient if it does not seek to create a highly mobile labor force.

BALANCE OF PAYMENTS WILL BE WORSENED

What will be the effect of tax reduction on our balance of payments? *First*, even the New Frontier economists will admit that the *immediate* effect will be adverse. The tax bill is intended to increase consumer spending. With an increase in consumer spending, an increase in imports will inevitably follow without any offsetting increase in our exports. As a *secondary* result, an increase in consumer spending

could well serve to raise the U.S. price level, which would adversely affect our exports. The administration argues, however, that increased consumer spending will *ultimately* serve to increase investment opportunity in the United States and thereby reverse the flow of capital to foreign investments. Even that is challenged by responsible economists.

Our balance-of-payments problem is not "long range." It is immediate. In fact, the administration proposes a so-called "interest equalization tax" in recognition of the urgency of this problem today, not at some distant day in the future. The tax bill will inevitably aggravate that problem, whether or not it might be helpful in the future, as optimistically hoped for by the administration.

THE TAX BILL CREATES GREATER COMPLEXITY AND INEQUITY

The tax bill adds some 300 pages mainly of so-called structural reforms to a statute already overburdened with exceptions, exemptions, special rules, and complex formulas. For the most part, these structural changes produce no revenue. Revenue-producing provisions in this bill are derived almost wholly from the limitation of the sick pay exclusion, the limitation of the deduction of certain State and other taxes, the limitation of the deduction for casualty losses, and the repeal of the dividend credit. Added together, these changes account for about 10 pages of the total of 300 pages in the bill. Not only does the bill fail to produce equity, it actually is a major step toward greater inequity. The revenue which will be derived from these changes will ultimately be more than offset by the $4.4 billion revenue loss which will result from the repeal of the so-called Long amendment to the investment credit (Section 202 of the bill).

The bill purports to raise $520 million in additional revenue by excluding certain State and local taxes as deductions. This burden will be borne solely by those individuals who itemize their deductions. No corresponding adjustment is made for those who elect to use the standard deduction. On the contrary, through the enlargement of the standard deduction it has been liberalized at a revenue loss of $320 million. This shifting of the tax burden certainly cannot be justified on the grounds of producing greater equity. It is the opposite.

Organized labor insisted that the dividend credit must be repealed. The administration acceded to that demand but, in order to make the repeal more palatable, provided a "sweetener" for the benefit of the lower income group. The repeal of the 4-percent tax credit for dividends received, while at the same time increasing the exclusion for such dividends from $50 to $100 per person, resulted in a further shifting of the tax burden. It certainly was not a "reform."

Innumerable other examples could be cited in this bill where political or other considerations resulted in "bad law." In effect, the structural reforms increase the taxes of the sick, of those who itemize deductions, and of those who invest in dividend-paying stocks, while giving a gratuitous "handout" of billions to big business by doubling the benefit of the investment credit. The tax system as a whole will be better if this bill is rejected by the Congress.

INVESTMENT CREDIT LOOPHOLE MADE BIGGER

In the Revenue Act of 1962 a tax credit or subsidy of 7 percent was provided for investors in depreciable property, other than real estate. By means of this credit, the taxpayer was reimbursed by the Government for $7 of each $100 invested in such depreciable property. The Republican members of the committee opposed this provision.

When the investment credit originally came before the House for consideration as part of the revenue bill of 1962, the Republican members of the committee pointed out that the investment credit was inherently discriminatory. In substitution thereof, the Republicans offered a "package" which would do equity to all taxpayers alike. The Republican proposal consisted of (1) a provision whereby taxpayers would be permitted accelerated depreciation on a basis comparable to the investment credit and (2) a provision where taxpayers would be permitted to set up an inventory reserve equal to 20 percent of the first $100,000 of finished goods in inventory. The Republicans said:

> The provision with respect to depreciation, when coupled with the revision of Bulletin F by the Treasury, should provide industry with the latitude in accounting for depreciation which has been overwhelmingly supported in the testimony before the committee. As a corollary to the relief to industry, we also believe that the Congress should grant relief to the small businessman who must reinvest his funds in inventory. Unless the wholesale and retail trades are willing and able to stock the goods produced by industry, any increased capacity to produce will remain idle.[20]

The Republicans in 1962 also proposed that, if the investment credit was to be adopted, the taxpayer's cost, whether for depreciation or for determining subsequent gain or loss on the sale of the property, should be reduced by the amount of the credit which the taxpayer had received on account of its purchase. This proposal was rejected by a majority of the committee, but was adopted as subsection (g) of section 48 when the 1962 bill was under consideration by the Senate Finance Committee. It became popularly known as the Long amendment.

Under the Senate amendment (Section 48 (g)), a taxpayer was required to reduce the cost or basis of the property for tax purposes by the amount of the investment credit. For example, if the taxpayer erected a new steel mill or a new pipeline at a cost of $100 million and received an investment credit of $7 million, the taxpayer would only be permitted to set up the property on its books at its net cost of $93 million. The effect of the Senate amendment was to deny the taxpayer a double deduction for an amount which the taxpayer had already recovered in full through the investment credit.

Even the Treasury recognized the discrimination in favor of big business which was inherent in the investment credit. The so-called "flip over" in this bill (whereby the normal tax rate applicable to corporations was reduced and the surtax rate increased) was advanced by the Treasury Department in recognition of the fact that small business had derived very little benefit from the investment credit. Nevertheless, the disparity will remain the same because the tax

[20] H. Rept. 1447, 87th Cong., 2d sess., p. B11 (1962).

benefits of the investment credit will be doubled through the repeal of the Senate amendment.

With the repeal of section 48 (g) of the Code, the taxpayer will not be required to reduce the basis of the property on account of the investment credit. The taxpayer will recover $100 in depreciation for each $93 of investment. The amount of the subsidy was, in effect, increased twofold. The investment credit became a 100-percent subsidy. The repeal of the Senate amendment will result in a revenue loss of $4.4 billion over the next 10 years, when we are supposed to be working towards a balanced budget. This loss will increase from year to year thereafter. (Table 7.)

TABLE 7.—*Estimated revenue loss resulting from repeal of subsec. (G) of sec. 48 of the Internal Revenue Code of 1954,*[1] *fiscal years 1964–73,*[2] *under present law tax rates and under tax rates reported by Ways and Means Committee*

[Millions]

Fiscal year (1)	Under present law tax rates (2)	Under tax rates reported by Ways and Means Committee (3)	Fiscal year (1)	Under present law tax rates (2)	Under tax rates reported by Ways and Means Committee (3)
1964	$15	$15	1970	$620	$560
1965	260	245	1971	685	615
1966	335	305	1972	745	670
1967	410	370	1973	805	725
1968	485	435			
1969	555	500	Total	4,915	4,440

[1] In the form of repeal agreed to by Ways and Means Committee on Aug. 25, 1963: effective July 1, 1963, the depreciation base for property eligible for the investment credit would not be reduced by the amount of the credit. In the case of property, the base for which has already been reduced, the taxpayer would increase the base by this amount and depreciate it in the future.

[2] Assuming an annual increase of 5 percent in investment in assets eligible for the investment tax credit (the rate of increase assumed by the Treasury in 1962 in projections of revenue impact of the investment tax credit and alternatives).

Source: Joint Committee on Internal Revenue Taxation, Sept. 6, 1963, estimate.

The repeal of the Senate amendment was approved by a majority of the committee, at the urging of the Treasury Department, on the representation that the Senate amendment unduly complicated the accounting for depreciable property. It has been described by the Treasury as a "bookkeeping" or "accounting" change. A revenue loss of $4 to $5 billion over 10 years certainly cannot be passed off as a "bookkeeping" or "accounting" change. This provision is a major substantive change in the law, which will create greater and greater inequity with the passage of time.

IS THE TAX CUT WORTH THE PRICE?

The fact is that the Congress is being called upon to enact an $11 billion tax cut at a time when, at the rate of expenditure growth projected by the New Frontier, it is facing long-range continuing deficits even without this tax cut. While we favor tax rate reduction as certainly desirable, can it be justified at the cost of Federal deficits of $10 billion or more for years to come? In view of the administration's failure to curtail its projected expenditure programs, the ultimate result is inevitable. Inflation and the cheapening of the

dollar—which already has lost much of its lustre abroad—will follow at home. That is the real fiscal price of this bill.

Does this bill offer any "gain" commensurate with the risk? Each must ask himself the question—are the modest savings in taxes worth adding billions to the Federal debt, to be passed on to the next generation? Or, should we first cut spending?

For the married taxpayer with two dependents and an income of $5,000, the tax reduction by the year 1965 ranges from a minimum of $77 per year for the taxpayer who itemizes to a maximum of $130 per year for the taxpayer who uses the standard deduction form. (Table 8.)

For the average wage earner, the bill results in a tax reduction of between $1.50 to $2 per week. Are these taxpayers willing to have the Government go into debt at the rate of $10 billion per year for the foreseeable future to give them the equivalent of "cigarette money"?

TABLE 8.—*Comparison of tax liability at various income levels under present law—Married taxpayer with 2 dependents*

Adjusted gross income (wage and salary income only)	With standard deduction [1]			With typical average itemized deductions [2]		
	Present law	Tax bill	Savings	Present law	Tax bill	Savings
$5,000	$420	$290	$130	$300	$223	$77
$7,500	877	686	191	720	576	144
$10,000	1,372	1,114	258	1,196	994	202
$15,000	2,616	2,172	444	2,213	1,865	348
$20,000	4,124	3,428	696	3,410	2,875	535

[1] For taxpayers who take the standard deduction, the impact of rate reduction and the minimum standard deduction under the tax bill.

[2] For taxpayers who itemize deductions, the impact of rate reduction and the disallowance of certain State and local taxes paid under the tax bill.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Aug. 20, 1963.

We have more confidence in the "basic puritan ethic" of the American people, than to believe that they are so anxious for "cigarette money" they will pass on to their children and to their grandchildren $10 billion of additional Federal debt each year. Is the benefit they will derive—a dollar or two per week—worth it? The people certainly did not think so before the administration unleashed its campaign of "indoctrination," or propaganda. Have the people been successfully "brainwashed" by the New Frontier pragmatists into suppressing their "puritan ethic"? We think not.

TAX BILL INCENTIVES MISPLACED

The tax bill is also deficient in that it seeks to bring about economic expansion through increasing consumer spending, rather than to provide more effective incentives for increased capital investment. In some respects the bill even penalizes the investor.

In 1954 Congress recognized the tax incident in regard to the three methods of corporate financing which was unequal with regard to new equity financing and resulted in a penalty exacted of corporate stockholders by taxing their corporate earnings at the rate of 52 percent and then taxing again the same income when distributed as dividends

to individuals. As a partial alleviation of this inequity the Congress exempted the first $50 of dividends received by an individual and allowed a tax credit of 4 percent for any dividend income in excess of the $50 exclusion.

Initially, the Kennedy administration recommended that the $50 exclusion and the 4-percent credit for dividends be repealed. It was claimed that the reduction of corporate taxes would alleviate the problem of double taxation. The committee rejected this proposal by a substantial majority. Subsequently, a "compromise" was offered whereby the 4-percent credit would be repealed, but the $50 exclusion would be raised to $100. After several efforts failed, the administration exerted sufficient pressure on the committee to bring about the approval of this "compromise" by a slim margin of one vote. How was this justified?

An unidentified labor economist put his finger on the crux of the matter. The 4-percent dividend credit was termed "class legislation." As this economist said, the repeal of this provision would affect less than 6 percent of American families. Even if this is correct, it does not make double taxation of investment earnings any more equitable. The repeal of this provision epitomizes the demagogic approach which has been resorted to time and time again by the majority.

The repeal of the tax credit on dividends is not only inequitable, but shortsighted. The Kennedy administration has constantly bemoaned the rate of economic growth, and exaggerated the unemployment problem. Tax proposals, trade bills, and other gimmicks have been foisted upon the Congress as economic stimulants to produce full employment. On the other hand, this bill sets about to take away one of the most justifiable stimulants to business investment. Equity capital is needed to create jobs. Yet, by the repeal of the 4-percent credit the tax on equity capital is made more burdensome.

The effect of making equity financing more burdensome will be to force the more heavy reliance on borrowing and retained earnings. The tax laws already impose a much lesser burden on the fruits of borrowed capital and retained earnings than on the fruits of equity capital. This has created a narrow equity base, which is more vulnerable to economic fluctuations. Stock prices are inflated because of imbalance between supply and demand. Industry is burdened with fixed interest charges on borrowed capital, rather than with the flexible dividend cost of maintaining high equity capital. A tax bill which is designed to expand the economy should provide greater, not lesser, incentives for equity capital.

At the corporate level, any incentive for greater investment is likewise taken away through the acceleration of corporate tax payments. The actual taxes to be paid by corporations having a tax liability in excess of $100,000 will not be significantly reduced under this bill for several years. The corporate payments have been accelerated so as to offset the effect of tax reduction. The so-called "cash flow," which will be available for investment in jobmaking facilities,

will not be materially increased on account of the reduction in rates until the calendar year 1969.

Finally, the combined rate structure and so-called "structural reforms" discriminate against the middle-income group on whom the economy must largely rely for investment funds. This group is the "backbone" both of managerial talent and investment funds. The tax relief for this group in the bill is considerably less than the tax relief which is granted to the lower income group and to the very rich. With respect to the middle income group, the administration has adopted the "filter down" theory. It is claimed that at some future date, increased corporate earnings, resulting from lower corporate taxes, will "filter down" to this group through the means of larger dividend payments. This certainly is no incentive, and provides no funds for tomorrow's investment.

CONCLUSION

The Republican members of the committee have always favored sound tax reduction and reform. In fact, the only major revision of our tax laws in the last 30 years was undertaken in the Eisenhower administration, over the vehement objection of many Democratic members of the committee. We sincerely believe that steps should be taken at the earliest practical date to further lighten the oppressive burden of taxation. However, this burden can only be permanently lightened as a part of a program simultaneously to bring Government expenditures more nearly in balance with tax revenues. The Republicans accomplished this in 1954, and there is no doubt that it could be done again. On the other hand, the Kennedy administration seeks tax reduction to bring about the opposite result. This is not a tax program, but merely a part of an overall program of planned deficits into the foreseeable future. That, we cannot support.

It cannot be said that the Nation's economy is faced with an imminent recession. The economic indicators cannot be relied on to justify recessionary measures. In fact, the economy has reached an "all time" high. In a period such as this, there is no justification for enlarging the Federal deficit through tax reduction. Faced with fiscal problems both at home and abroad, we should be moving toward a balanced budget.

In many respects, the tax bill itself is deficient. Sound tax legislation should simplify, not compound tax problems; remove, not add complexities to the law; and as a bare minimum, avoid creating or enlarging "loopholes." As was the case in 1962, this bill is another "patchwork" of tax juggling, which fails to meet these tests. However, our objection is more basic.

For the welfare of the Nation, the Republicans must adhere to the principle of "fiscal responsibility." This is basic for the survival of our free system. It is not a partisan concept. In fact, it is Jeffersonian in origin. It is axiomatic that the only real restraint on the Government's proclivity to spend is the people's willingness to pay the taxes to finance those expenditures. When we abandon this principle we undermine the very foundation of a free society. That

is why we must oppose the fiscal policy of this administration, of which the tax bill is an integral part. We believe that it is morally and fiscally wrong, and will do irreparable damage to the Republic.

John W. Byrnes.
Thomas B. Curtis.
Victor A. Knox.
James B. Utt.
Jackson E. Betts.
Bruce Alger.
Steven B. Derounian.
Herman T. Schneebeli.
Harold R. Collier.

ADDITIONAL VIEWS OF HON. HOWARD H. BAKER

I join in the additional views of my colleague, Hon. Herman T. Schneebeli, to the following extent:

> I am in full agreement with my Republican colleagues that tax reduction of $11 billion based upon a mere wish or a hope that expenditures will be controlled is fiscally irresponsible. Mere protestations of economy on the part of the Kennedy administration, which are belied by its actions in constantly presenting new and expanding expenditure programs to the Congress, are not sufficient to convince me that we will be able to balance the budget for the foreseeable future.
>
> On the other hand, I am convinced that the excessive tax burden should be alleviated both with respect to individuals and with respect to business. While there is considerable risk in reducing taxes before reducing expenditures, I would be willing to take that risk if tax reduction were accompanied by a corresponding statutory deterrent to increased spending.
>
> Such a deterrent was presented by the amendment offered by the Republicans in committee whereby the second stage of the tax reduction, scheduled to take effect January 1, 1965, would be forestalled if expenditures exceeded certain specified levels. I am confident that the House of Representatives will have the opportunity to vote on this proposal. This amendment was narrowly rejected by the committee, only as a result of extreme administration pressure. If the administration is sincere in its stated intention of holding down expenditures, it should not oppose an amendment that merely translates this intention into legislative language.
>
> *   *   *   *   *
>
> We have am opportunity to allay these fears by adopting an effective restriction on the ever-increasing Federal deficits which are at the root of these problems.
>
> We offer a specific and certain brake on Federal expenditures and deficits, without which the majority of our people, including former Presidents Truman and Eisenhower, are opposed to this bill.
>
> The confidence of business would be restored in the knowledge that impending runaway Federal deficits were being restrained by this legislative formula, which would serve to test each expenditure against the pocketbook of the voter.
>
> In my opinion, the adoption of the proposal, whereby the second stage of the tax reduction to take effect January 1, 1965, would be forestalled if the Kennedy administration does not keep its promises to maintain closer control over

> expenditures, would offset the fiscal risks involved in enacting this bill in the face of a large deficit for fiscal 1964. * * * Accordingly, I hope that the expenditure-control amendment will receive favorable consideration by the House, as I believe in tax reduction and would like to vote for this bill.

Comprehensive tax reduction and tax reform conditioned upon mandatory statutory control of expenditures leading to the elimination of deficits and reestablishment of balanced budgets is the basic concept of the Herlong-Baker tax bills, which have been introduced by the gentleman from Florida, Mr. Herlong, and myself over a period of years, and which have attracted wide support over the Nation.

The Herlong-Baker proposals are bipartisan in nature.

I am convinced that the only method of accomplishing balanced budgets and comprehensive tax reduction and revision is by statutory restraint upon both the Congress and the executive department.

If this proposal, which was initiated by me in the committee, to make the second stage of the tax reduction provided for in H.R. 8363 contingent upon no further increase in expenditures is adopted, it is my intention to support the bill on final passage.

Howard H. Baker.

ADDITIONAL VIEWS OF HON. VICTOR A. KNOX

I have joined as a signatory to the Republican views which appear in an earlier part of this report. Those views present irrefutable argument in pointing out the fiscal fraudulence involved in attempting to grant tax reduction while the administration actively resists efforts to control mounting Government spending. Each dollar of tax reduction granted under existing fiscal conditions will add $1 to our public debt.

I am prompted to file these additional separate views to comment further on what I believe to be the appropriate course of action in behalf of sound tax reduction. I voted to report this legislation to the House because I believe that substantial tax reduction is an urgent national necessity to relieve the currently existing oppressive tax burdens that have thwarted economic development.

In voting to report this bill I expressively reserved my rights in connection with its subsequent legislative consideration. I am convinced that an essential condition precedent to the final approval of tax reduction must be the adoption by the Congress of a meaningful and effective control over spending. It is my considered judgment that the membership of the House should be given opportunity to decide the crucial issue of whether or not the Federal Government should spend less so that we can tax less. This bill should not be supported for final passage if the end result of the House action is to affirm the declared administration policy of spending more and taxing less.

If success is attained in establishing a firm and effective demonstration of the Congressional intent to control spending, then I believe, on balance, this legislation merits the support of the House membership. I reach this conclusion even though I am concerned and disappointed over many features of this tax bill. For example, I believe it is not proper to remove 1.5 million persons from our tax rolls under the present budgetary situation. I believe that many of the substantive changes contained in the bill are contradictory to the stated objectives of encouraging investment, increasing job opportunities, and improving the equity in our tax structure. Specifically I believe that the allocation of tax relief among income classes could be more fairly accomplished than under the formula contained in this legislation. The substantive changes reimposing double taxation on dividend income, taxing certain group-term life insurance premiums, denying the deductibility of certain State and local taxes, and imposing unnecessarily stringent rules in regard to stock options should be modified as a result of further congressional consideration prior to the time this legislation becomes public law. I am also concerned that the economic growth prospects from tax reduction will be impaired by the impact of the acceleration of corporate tax payments upon the corporate cash flow.

In the three decades that I have been in public office I have never thought the time would come when I would have misgivings over a tax

reduction program urged by the Executive. I have misgivings over this proposal to provide tax reduction in the context of our existing fiscal posture because the administration seeks to finance the cost of the reduction out of substantially increased deficits rather than through Government economy. It is within the authority and the responsibility of the Congress to make tax reduction sound and feasible in 1963 by manifesting now its determination to enforce frugality in spending.

Private enterprise can flourish and Government enterprise can be restrained within proper bounds only by imposing on our people the minimum tax burden consistent with out obligation to pay our own way.

I urge my colleagues in the House to support the efforts that will be made to achieve both spending reduction and tax reduction this year.

VICTOR A. KNOX.

ADDITIONAL VIEWS OF HON. HERMAN T. SCHNEEBELI

I am in full agreement with my Republican colleagues that tax reduction of $11 billion based upon a mere wish or a hope that expenditures will be controlled is fiscally irresponsible. Mere protestations of economy on the part of the Kennedy administration, which are belied by its actions in constantly presenting new and expanding expenditure programs to the Congress, are not sufficient to convince me that we will be able to balance the budget for the foreseeable future.

On the other hand, I am convinced that the excessive tax burden should be alleviated both with respect to individuals and with respect to business. While there is considerable risk in reducing taxes before reducing expenditures, I would be willing to take that risk if tax reduction were accompanied by a corresponding statutory deterrent to increased spending.

Such a deterrent was presented by the amendment offered by the Republicans in committee whereby the second stage of the tax reduction, scheduled to take effect January 1, 1965, would be forestalled if expenditures exceeded certain specified levels. I am confident that the House of Representatives will have the opportunity to vote on this proposal. This amendment was narrowly rejected by the Committee, only as a result of extreme administration pressure. If the administration is sincere in its stated intention of holding down expenditures, it should not oppose an amendment that merely translates this intention into legislative language.

Why is it that more than 72 percent of my constituents and over 80 percent of the business leaders in my District, when directly queried, voted to forego the benefits of the proposed tax cuts? We all know the answer: It is because of the mounting fears over our growing public debt at home and the run on our gold from abroad.

We have an opportunity to allay these fears by adopting an effective restriction on the ever-increasing Federal deficits which are at the root of these problems.

We offer a specific and certain brake on Federal expenditures and deficits, without which the majority of our people, including former Presidents Truman and Eisenhower, are opposed to this bill.

The confidence of business would be restored in the knowledge that impending runaway Federal deficits were being restrained by this legislative formula, which would serve to test each expenditure against the pocketbook of the voter.

In my opinion, the adoption of the proposal, whereby the second stage of the tax reduction to take effect January 1, 1965, would be forestalled if the Kennedy administration does not keep its promises to maintain closer control over expenditures, would offset the fiscal risks involved in enacting this bill in the face of a large deficit for fiscal 1964. Under those circumstances, I would support the bill. Accordingly, I hope that the expenditure-control amendment will receive favorable consideration by the House, as I believe in tax reduction and would like to vote for this bill.

HERMAN T. SCHNEEBELI.

REVENUE ACT OF 1964

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[H.R. 8363][1]

REVENUE ACT OF 1964

[Senate Report No. 830, Eighty-eighth Congress, Second Session, Calendar No. 805]

[January 28, 1964]

Mr. LONG, of Louisiana, from the Committee on Finance, submitted the following report together with individual and minority views to accompany H.R. 8363.

The Committee on Finance, to whom was referred the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY

This bill, H.R. 8363, the Revenue Act of 1964, provides $11.6 billion of tax reduction scheduled over a 2-year period, the bulk of the relief, however, becoming effective within a month of enactment. The bill will cut back on excessive tax rates which unnecessarily restrain individual and business incentives, it will provide the increased consumer and business purchasing power to assure continued expansion, and it will improve the equity of the tax system.

(a) Revenue.—The bill when fully effective in 1965 will reduce tax liabilities of individuals by $9.2 billion and of corporations by $2.4 billion. At constant income levels the bill would reduce receipts by $1.9 billion in fiscal year 1964 and $8.4 billion in fiscal year 1965 (including the $1.9 billion reduction from 1964). Taking into account the effect of this reduction in increasing private expenditures and income, the net effect on revenues is expected by the Treasury Department to be a reduction of $1.7 billion in fiscal year 1964 and $4.3 billion in fiscal year 1965.

[1] Public Law 88–272, page 6, this Bulletin.

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(*b*) ***Rate reduction.***—

1. ***Individual.***—As in the House bill, individual rates are reduced from the present range of 20 to 91 percent to a new range of 16 to 77 percent in 1964 and to 14 to 70 percent in 1965. The bill provides that the withholding rate, presently 18 percent, will be reduced to 14 percent, effective within a week after enactment.

2. ***Corporate rate.***—As in the House bill, the tax rate for corporations in 1964 is reduced from 52 to 50 percent and is further reduced in 1965 to 48 percent. In addition, the rate applicable to the first $25,000 of corporate income beginning in 1964 is reduced from 30 percent to 22 percent. Furthermore, corporations are placed on a full pay-as-you-go basis so that ultimately all of their tax liability above $100,000 is to be payable in the year in which it is earned. This is achieved over a 7-year period so that it will not increase corporate cash outlays for tax payments in any year of the transitional period.

(*c*) ***Structural changes.***—In addition to rate changes the bill provides a number of provisions designed to increase the equity of the present tax law. Some of these increase and others decrease the revenue. The major items are:

1. ***Minimum standard deduction.***—The bill provides that each taxpayer may have a minimum standard deduction of $300 plus $100 for each additional exemption. This relieves from tax all single individuals with incomes up to $900, and all married couples with incomes up to $1,600.

2. ***Dividend credit and exclusion.***—The 4-percent dividend received credit is reduced by the bill to 2 percent for 1964, and repealed for subsequent years. The $50 dividend exclusion is increased to $100 for 1964 and subsequent years. In practical effect, this increase is from $100 to $200 for married couples.

3. ***Retirement income credit.***—The bill provides that in computing the retirement income credit the limit on retirement income is to be raised from $1,524 to $2,286 in certain cases where a joint return is filed.

4. ***Investment credit.***—In the case of the investment credit, the bill (*a*) repeals the provision requiring a 7-percent downward adjustment in the basis of property eligible for depreciation to the extent that the investment credit applies; (*b*) prevents regulatory commissions in certain cases from requiring the "flowthrough" of the benefits of the investment credit to the customers of regulated industries; and (*c*) makes other revisions in the investment credit.

5. ***Group term insurance.***—The bill limits the employee exclusion for premiums on group term insurance furnished through the employer to premiums paid for the first $70,000 of coverage.

6. ***Sick pay exclusion.***—The bill restricts the sick pay exclusion, of up to $100 a week, only to those who are absent from work for more than 30 days (and makes the exclusion available only for the period beyond that time).

7. ***Sale of residence by aged taxpayer.***—The bill provides an exclusion from the tax base for the gain attributable to the first $20,000 of the sales price of a personal residence in the case of an individual aged 65 or over.

8. ***Deduction of certain State and local taxes.***—The bill denies a deduction in computing income subject to Federal tax for State and

local taxes other than property, income, general sales taxes, gasoline, and auto license (the principal taxes for which a deduction is denied are alcoholic beverage, cigarette, and selective excise taxes).

9. ***Casualty loss deduction.***—The deduction for personal casualty and theft losses is limited to the amount in excess of $100 per loss (similar to "$100 deductible" insurance).

10. ***Charitable contribution deduction.***—Several changes are made in the charitable contribution deduction: (*a*) The 30-percent maximum deduction is made available generally for contributions to publicly supported organizations other than private foundations; (*b*) the 2-year carryover of charitable contributions for corporations is extended to 5 years; (*c*) a 5-year carryover is provided for individuals with respect to contributions to publicly supported organizations; (*d*) the unlimited charitable deduction is restricted to contributions to publicly supported organizations; and (*e*) charitable contributions deductions for future interests in tangible personal property are denied until the gifts are completed.

11. ***Foreign expropriation losses.***—The bill permits a taxpayer which has sustained a substantial foreign expropriation loss after 1958 to carry over that portion of a net operating loss arising from the foreign expropriation loss for 10 years without any carryback.

12. ***Medical expense deduction.***—The 1 percent limitation, or floor, on medicines and drugs which must be taken into account in determining deductible medical expenses is made inapplicable where the taxpayer or his wife is over 65 and also with respect to such expenses for dependent parents over 65.

13. ***Child-care expense deduction.***—The child-care deduction is revised (*a*) to make it available in the case of a wife who is incapacitated; (*b*) to make it available with respect to care for children up to age 13 (instead of 12); (*c*) the maximum deduction allowable where there are two or more children is increased from $600 to $900, and to $1,000 where there are three or more children; and (*d*) the present limit on the family income in the case of a working wife is raised from $4,500 to $7,000.

14. ***Moving expense deduction.***—A deduction for certain moving expenses—transportation of the household goods and the persons involved, and also their meals and lodging while in transit—is allowed for employees who are not reimbursed for these expenses and also for new employees (an exclusion for these items is already available in the case of old employees who are reimbursed). Old employees who are reimbursed for certain costs and losses in connection with the sale of their old home, occasioned by a move, are permitted to treat the reimbursement as sale proceeds rather than compensation.

15. ***Political contribution deduction.***—The bill allows individuals a deduction, limited to $50 a year ($100 on a joint return) for contributions to any political candidate or political committee to further the candidacy of individuals.

16. ***Intercorporate dividend deduction for certain affiliated groups.***—The bill provides that certain affiliated groups eligible to file a consolidated return, but not doing so, may take under certain conditions a 100-percent deduction for intercorporate dividends received from other members of the group if the group agrees to be treated as a single entity for certain purposes, such as the surtax exemption.

17. ***Face amount certificate companies.***—The bill provides that a "face amount certificate company" shall not be subject to disallowance of a deduction on interest paid with respect to face amount certificates under section 265(2) of the code (relating to interest indebtedness to carry tax-exempt bonds on tax-exempt income) to the extent that tax-exempt obligations do not constitute more than 25 percent of the average of the total assets.

18. ***"Bank loan" insurance.***—An interest deduction is denied for amounts borrowed under a systematic plan to pay premiums on life insurance (certain exceptions are provided).

19. ***Corporate reorganizations.***—The bill provides tax-free status to a stock-for-stock reorganization, where the corporation acquiring the stock exchanges either its voting stock or the voting stock of a corporation which is in control of the acquiring corporation.

20. ***Travel expense deduction.***—The bill repeals the rule, adopted in 1962, which disallows a portion of travel expenses for certain business trips which are combined with a vacation.

21. ***Pension plans.***—The bill permits retroactive qualification for certain pension plans under multi-employer collective bargaining agreements. It also permits a U.S. corporation to extend coverage under its qualified pension, profit sharing, etc., plan to certain U.S. citizens employed by subsidiaries operating outside of the United States.

22. ***Stock options.***—The present tax treatment of employee stock options is further restricted, the principal additional restrictions being: (*a*) the stock when acquired must be held for 3 years or more; (*b*) the option must not be for a period of more than 5 years; (*c*) the option price must at least equal the market price of the stock when the option is issued; (*d*) stockholders' approval for the options must be obtained; and (*e*) the extent to which new options may be exercised when the old options are outstanding is restricted. Separate tax treatment is provided for employee stock purchase plans which are available to all employees on a nondiscriminatory basis under rules which are substantially the same as under present law.

23. ***Installment method.***—The bill treats all revolving credit sales as installment sales for tax purposes and also treats time payment charges as installment sales.

24. ***Deduction of contested liabilities.***—The bill would allow a deduction for the taxable year in which a taxpayer pays a tax or other liability, even though he contests the liability.

25. ***Interest on certain deferred payments.***—Where property is sold on an installment basis and either no, or very low, interest is charged on the installments, the bill provides that an appropriate amount of each installment is to be treated as if it were an interest payment.

26. ***Personal holding companies.***—The percentage of passive income which may result in a company being classified as a personal holding company is reduced from 80 to 60 percent and amendments are made so that the tax cannot be avoided by using rental income or oil or gas or mineral royalties (or working interests) to shelter substantial amounts of investment income, such as dividends and interest, from the personal holding company tax. Other restrictive amendments are also made. Relief is provided for those companies which are not now personal holding companies, but which would be

under the new definitions. They are permitted favorable liquidation treatment in certain cases and also permitted a deduction, in computing the personal holding company income, for paying off existing debts.

27. ***Aggregation of oil and gas properties.***—For the future, oil and gas leases or acquisitions are no longer to be aggregated in determining what constitutes a property for purposes of computing the percentage depletion deduction.

28. ***Iron ore royalties.***—The bill provides capital gains treatment for certain domestic iron ore royalties.

29. ***Life insurance companies.***—The bill makes three changes with respect to the income tax of life insurance companies: (1) It removes the requirement of present law that life insurance companies, and mutual insurance companies electing to be taxed on investment income only, are to ratably accrue market discount on purchased bonds as ordinary income; (2) it extends to 1962 the rule for deductibility of certain distributions to shareholders pursuant to certain mutualization plans; and (3) it assures deductibility of qualified pension plan contributions of mutual insurance companies.

30. ***Regulated investment companies.***—The bill amends the regulated investment company provisions (1) by increasing from 30 to 45 days after the close of the taxable year the time for giving certain notices to shareholders, and (2) by providing that distributions by a unit investment trust liquidating an individual's interest are not to be considered as giving rise to capital gains tax with respect to interests of other investors still in the trust.

31. ***Foreign tax credit on mineral operations.***—The bill provides that any excess foreign tax credit which arises from mineral extraction, because of the percentage depletion allowance under U.S. law, may not be used to offset U.S. tax on income not related to mineral extraction, processing transportation or marketing.

32. ***Sale of depreciable real estate.***—In the case of real estate sold in the future, any depreciation deductions, generally to the extent these deductions exceed depreciation allowable under the "straight line" method (to the extent of the gain), will be treated by the bill as giving rise to ordinary income. However, in the case of property held more than 20 months the amount treated as ordinary income will be reduced by 1 percent for each month of holding over 20, with the result that no amount will be treated as ordinary income in the case of real property held more than 10 years.

33. ***Averaging of income.***—The bill in effect provides for the averaging of income over a 5-year period where the income in the current year exceeds the average of the 4 prior years by more than one-third and this excess is more than $3,000.

34. ***Subchapter S corporations.***—The bill amends the provisions for subchapter S corporations to provide (1) that certain distributions of money made after the close of a taxable year may be treated as made at the close of that year in order to prevent double inclusion of income, and (2) that a corporate member of an affiliated group may elect subchapter S treatment where the only other members of the group are inactive subsidiary corporations.

35. ***Repeal of consolidated returns tax.***—The 2-percent penalty tax, which must presently be paid by corporations for the privilege of filing consolidated returns, is repealed.

36. ***Multiple surtax exemption.***—For corporations where there is common control to the extent of 80 percent or more, the corporations involved generally are limited to one $25,000 surtax exemption for the group or alternatively required to pay a special tax of 6 percent on the first $25,000 of their income. No penalty tax is imposed where a consolidated return is filed for the group.

37. ***Tax lien on automobiles.***—A purchaser, mortgagee, or pledgee of a motor vehicle will not be subject to a Federal tax lien against the motor vehicle, notice of which has been publicly filed, unless the purchaser, mortgagee, or pledgee had actual knowledge of the existence of the lien.

II. GENERAL STATEMENT

H.R. 8363 represents a basic revision of the Federal income tax laws. By substantially reducing individual and corporate tax rates, it is anticipated that this bill will stimulate higher investments and increase consumer purchases. In this manner, the bill is designed to lessen unemployment and to increase the rate of growth of our productive capacity. The bill also contains a series of structural changes in the tax system designed to improve the equity of the system and to close loopholes.

The extensive public hearings held by your committee have provided convincing evidence of the wide area of agreement on the part of the public generally—including representatives of both business and labor—of the need for reducing our present unrealistically high individual income tax rates. At present, they range from 20 to 91 percent and under this bill are reduced to a range of 14 to 70 percent. Also in the case of corporations, by reducing the top rate from 52 to 48 percent, this bill converts the Government from a "senior partner" to a "junior partner" in any business undertaking. The present high income tax rates are a carryover from the tax policy of World War II and the Korean war when the dampening down of investment stimulants and holding the line on consumption were necessary to our wartime effort. These policies are no longer appropriate, however, in our economy today.

Despite the fact that business conditions have been improving over the past 33 months, unemployment still is at the high rate of 5.5 percent, which matches the unemployment rate in the 1954 recession. Since obtaining an unemployment rate of 4.2 percent in 1956, we have experienced a succession of disappointing recoveries in which the unemployment rate has remained disturbingly high; this rate, in fact, has not been below 5 percent since 1957.

Added significance for this persistent high rate of unemployment lies in the fact that the next decade will be a period of unusually high growth in the labor force as the children of the post-World War II era come of age. The annual growth in the labor force as a result can be expected to increase from less than 1 million to about 1½ million. In addition, it is expected that with an improvement in employment conditions, perhaps 1 million people not now seeking work will return to the labor market. This shows quite clearly that the growth rate of our economy must be increased if the requisite jobs are to be found for this expanding labor force.

Although business conditions were generally good in 1963, the level of new investment in business plant and equipment was scarcely 6 percent above the level of investment in 1957, despite the 31-percent increase in the gross national product during this period.

The existence of these underutilized resources of manpower and plant capacity means that it is possible to attain a faster economic growth through tax reduction without significant inflationary pressures. The 5-year stability of the wholesale price index, together with the relatively moderate increase in the consumers' price index, in recent years, is evidence of this. The goal of a balanced growth with stable prices will, of course, also call for restraint in Government expenditures.

Tax reduction is also important as an aid in the reduction of our persistent balance-of-payments deficit. The presence of greater investment incentives and opportunities abroad than at home is the root cause of American capital seeking foreign outlets. The expanding markets resulting from the tax reduction contained in this bill will raise the attractiveness of domestic investment. Moreover, a faster domestic growth rate will result in a larger flow of new products and technological improvements, making our exports more competitive. The substantial improvements in our balance-of-payments position in the last 6 months is further evidence that an improvement in domestic business can aid our foreign balance. This also has been the experience in Europe where is is the rapidly growing and modernizing economies that have strong currencies.

(a) Tax reduction and revenues

The record of economic performance below capacity over the last 6 years has left a heavy mark on the Federal debt. The initial budget forecast for each of the fiscal years 1958–63 was for a budgetary surplus. The actual outcome in 5 out of the 6 years was a deficit with the deficit averaging about $5 billion.

The major factor in each of these deficits was the failure of the economy to expand as predicted. Either the present or proposed tax rates are high enough to produce a substantial budgetary surplus in a few years if there is sufficient growth and the economy operates at a high level. The present rates, however, constitute such a drag on the economy that the rate of growth has been disappointing and the rate of operation remains low. As a result, income and profits are relatively low and tax receipts are lower than would otherwise be the case. This is the principal factor accounting for the budgetary deficits.

The size of tax receipts is attributable to two variables, the tax rates and the tax base. The major thrust of the present tax bill is to provide a long-range expansion in one of these variables—the tax base—and thereby to increase the revenue potential. To accomplish this result the bill encourages the expansion of the private, rather than public, sector of the economy.

The present tax bill, along with a policy of expenditure constraint offers promise of restoring a balanced budget by the fiscal year 1967 or 1968. During a year of healthy growth in our economy the yield of the present tax system will increase in the neighborhood of $5 billion to $6 billion. The reduction in tax rates under this bill is designed to maintain that high rate of growth which will provide

sufficient additional revenue to cover the cost of the tax bill in a relatively short period of time.

It may be argued that taxes should not be cut while there is a budget deficit. However, this overlooks the fact that maintaining high tax rates does not produce more revenue unless the tax base expands sufficiently—and the rates themselves inhibit this expansion. It is your committee's considered judgment that with the current rates it would take longer to eliminate the deficit than would be the case with the lower rates of this bill but with the expanded economy induced by this bill.

(b) Expenditure control

The House bill in section 1 contains a statement of policy as to the need to stimulate the economy and in this manner raise revenues. It also states that to further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

The accord of your committee with the first of these statements is evidenced by its approval of the tax reduction provided by this bill and in the views expressed above that this legislation will, in the long run, increase rather than decrease revenues.

Your committee is also in accord with the second of these statements. The fact that your committee is reporting this bill after the presentation of the President's budget for the fiscal year 1965 is fortunate in that now the restraint of Government spending not only has been stated as an objective of administration policy but also is evidenced by the budgetary figures themselves. This budget reduces the deficit in the administrative budget by more than one-half from $10 billion to $4.9 billion. It also reflects a substantial decrease in new obligational authority requested and actually provides for a slight reduction—from $98.4 billion to $97.9 billion—in the level of spending for the fiscal year 1965. In view of these considerations, your committee believed that the retention of section 1 of the House bill was unnecessary. Moreover, it is questionable whether expressing declarations of intent in tax legislation would be a desirable precedent. Intent to restrain Government expenditures can best be evidenced by action on appropriation bills as they are presented in this session of Congress.

(c) The structure of tax reduction

This bill provides a balanced reduction between individuals and business firms. In this respect, the bill is much the same as the bill that came from the House. When fully effective, the bill will reduce individual income taxes by $9.2 billion and will reduce corporate taxes by about $2.4 billion. These figures must be evaluated along with the effective tax reduction of 1962 through the investment credit and depreciation reform, the largest share of which went to corporations. Taking the 1962 and 1964 programs together, the share of the reduction going to individuals is about two-thirds and to corporations about one-third, which is approximately the present relative shares of individuals and corporations in income tax liabilities.

Looked at another way, the net individual income tax reduction will reduce present tax liabilities for individuals by just under 20 percent. The combined effects of this bill, depreciation reform, and

last year's investment tax credit, will reduce corporate tax liabilities by something more than 19 percent.

The bill equitably distributes tax reduction over the various individual income tax levels. Those at the lowest income levels will receive the largest tax reductions, measured as a percent of the present tax. This reduction of 38.6 percent of present law tax at these levels is due to the sharper reductions in the first bracket rate, the split first bracket, and the effect of the minimum standard deduction. Due to the structural reforms, particularly the repeal of the dividends received credit the amount of tax reduction for persons with incomes of $50,000 or more will average approximately 13.5 percent of their present tax (excluding the alternative capital gains tax). Since the present tax for these individuals is already considerably higher relative to income than it is for those with incomes below $3,000, this 13.5-percent reduction in tax necessarily represents a greater increase in aftertax income.

In addition to a rate reduction the present bill contains a number of provisions designed to increase the equity of the tax system, some of which increase and some of which decrease the total revenue. These provisions are listed in part I above.

The bill also significantly improves the pattern of progression in the tax structure. At the lower end of the income tax scale, the minimum standard deduction will effectively eliminiate tax for all single people with adjusted gross incomes below $900 and for married couples with incomes below $1,600 (with higher minimum levels of $700 for each dependent). Furthermore the division of the present first surtax bracket (which is $4,000 wide for a married couple) into four narrower brackets permits greater proportionate tax reduction for families and single individuals whose total income leaves them close to a poverty level.

At the upper end of the income scale, under the demands of war finance, progression has been carried to the extreme of rates that under peacetime conditions are clearly excessive and inhibit individual initiative. Over the years the Congress has been faced with the necessity of making statutory exceptions, through special deductions, lower capital gains rates and the like, until there now is a wide range of effective rates applicable to people with the same economic income. Your committee's bill deals with this problem by applying the reductions made in these higher brackets to those cases where current rates are excessive and also by removing special benefits in the law which account for part of this divergence in rates.

(*d*) *Principal changes from the House bill*

Your committee's amendments make a number of changes in the House bill. These are:

(1) The 14-percent withholding rate, scheduled under the House bill to become effective in 1965, is made effective in 1964, 8 days after the enactment of this legislation. This change is needed because lower tax rates will apply to all of 1964 incomes but withholding will continue at 18 percent (rather than the 15 percent provided in the House bill) until this bill goes into effect.

(2) The restoration of the deduction for State and local taxes on gasoline and for other State and local registration taxes on automobiles. Under the House bill individuals who itemize their personal deductions were not to be allowed deductions for these items.

(3) The deletion of the House provision reducing the tax rate on capital gains where the assets have been held more than 2 years. Under the House bill certain capital gains held more than 2 years were to achieve an effective lower rate of tax by the reduction of the percentage of such gains included in income from 50 to 40 percent and by the reduction of the alternative tax rate on these gains from 25 to 21 percent. Your committee believes that further reduction in capital gains should be deferred until Congress has a further opportunity to examine these rates and related problems. Even though the capital gains provisions are not reduced in this bill, those who include half of their capital gains in their regular income tax base (96 percent) will obtain under this bill the same percentage tax reduction on these capital gains as is applicable to other kinds of income.

(4) The taxation of group term insurance paid for through the employer is to apply to the cost of insurance for over $70,000 of coverage rather than $30,000 as provided by the House bill.

(5) A new deduction for political contributions of up to $50 a year for a single person and up to $100 a year for a married couple is provided.

(6) The child-care deduction is liberalized, particularly with respect to working wives. Under present law this deduction is reduced in the case of a working wife by the excess of the family income over $4,500. The bill raises this limitation to $7,000.

(7) A new provision is added limiting the use of excess foreign tax credits arising from mineral extraction. Where the foreign tax on the extraction activity exceeds the U.S. tax, because of the allowance of percentage depletion under the U.S. tax, the resulting excess foreign tax credit may not be used against U.S. tax on income arising from nonmineral activities.

(8) The limitation on the business travel expense deduction enacted in the Revenue Act of 1962 is repealed. Thus there will no longer be an allocation of the travel expense where the taxpayer combines a business trip with a vacation.

(9) A new provision provides that where an employee moves and the employer reimburses him for selling costs on his house and losses incurred on the sale of the house attributable to the fact that it must be sold more quickly than usual, the reimbursement is to be treated as a part of the selling price of the house (rather than as compensation).

(10) Groups of affiliated corporations eligible to file a consolidated return and those eligible which do not do so, will be permitted to take a 100 percent dividends received deduction with respect to dividends received from other members of the controlled group, provided the group elects to take only one surtax exemption and meets certain other conditions.

(11) A new provision is added extending the installment method of accounting to business firms maintaining so-called revolving credit accounts.

(12) A new provision is added to allow taxpayers who suffered losses through foreign expropriation after 1958 to carry these losses forward for 10 years (instead of the usual 3-year carryback and 5-year carryforward).

(13) A new provision liberalizes the retirement income credit. This increases the amounts of retirement income on which the credit is computed to make the credit more nearly analogous to the social security exclusion.

(14) A 5-year carryover of unused charitable contributions is provided for individuals, deductions for gifts of future interests are restricted, and contributions to private foundations are made ineligible for the unlimited charitable contributions deduction.

(15) A new amendment provides that companies issuing face amount certificates may invest up to 25 percent of their total assets in tax-exempt obligations without losing a deduction for interest paid to the shareholders.

(16) A new amendment provides a tax-free status for a stock-for-stock reorganization where the corporation acquiring the stock exchanges the stock of its parent for the stock of the acquired corporation.

(17) A new provision provides for the retroactive qualification of union negotiated multiemployer pension plans where these pension plans are subsequently qualified.

(18) A new provision makes possible the coverage under qualified pension plans of U.S. employees of foreign subsidiaries or of U.S. employees of foreign branches of domestic corporations.

(19) In the case of employee stock options, the House provision is liberalized with respect to the restrictions imposed where one option is outstanding and a subsequent option is acquired and the effective date is changed to apply to options granted after December 31, 1963 (instead of June 11, 1963).

(20) A new provision provides that in the case of contested liabilities, the deduction is to be taken in the year of the payment where this occurs before the contest is settled.

(21) The personal holding company provision of the House bill is liberalized somewhat in the case of the test as to when rent is considered personal holding company income and also with respect to the exemptions for consumer finance companies.

(22) Three new provisions are added with respect to insurance companies, providing additional time for special treatment mutalization distributions, providing capital gains treatment with respect to the accrual of bond discount in certain cases, and correcting a technical error in present law.

(23) Liberalizing amendments are provided giving regulated investment companies more time for the mailing of notices to shareholders and with respect to the treatment of redemptions by unit investment trusts.

(24) An amendment liberalizes somewhat the treatment accorded "small business corporations"; namely, those treated essentially like partnerships for tax purposes.

(25) An amendment provides that a purchaser, mortgagee, or pledgee of a motor vehicle will not be subject to a Federal tax lien against the motor vehicle unless the purchaser, mortgagee, or pledgee has actual notice of the existence of the lien.

III. REVENUE ESTIMATES

The revenue effect of your committee's bill is shown in tables 1 through 4 below. (Pt. A of tables 1 through 3 refers to estimates under your committee's bill and pt. B in each case to estimates under the House bill.) Estimates in the tables are based on income levels assumed for the calendar year 1963 but do not take into account any "feedback" to the economy anticipated from this bill. Table 1 shows the estimated impact of the various provisions contained in your committee's bill and the House bill upon calendar year 1964 and 1965 tax liabilities and also upon liabilities in the long run. Table 2 shows the estimated effect of your committee's bill and the House bill upon receipts in the fiscal years 1964 and 1965.

Table 1 indicates that your committee's bill can be expected to decrease calendar year 1964 tax liabilities by $7.9 billion and calendar year 1965 liabilities by $11.6 billion (the latter figure includes the $7.9 billion reduction). The calendar year 1965 effect is virtually identical with the long-term effect of the bill before taking into account any impact of the reductions upon the economy. Of the $11.6 billion reduction in 1965, $9.2 billion will go to individuals, or nearly 80 percent of the total. Revenue raising structural changes for the calendar year 1965 amount to $740 million but are partially offset by other liberalizing provisions reducing the net increase to $160 million.

Table 2 shows that your committee's bill will decrease revenues in the fiscal year 1964 by $1.9 billion and in the fiscal year 1965 by $8.4 billion (the latter figure includes the $1.9 billion reduction). These figures are considerably lower than the calendar year liability figures for the same year; first, because of the fact that the fiscal year ends in the middle of the calendar year; and, second, because the calendar year data are shown on the basis of liability rather than receipts. Liabilities indicate the amount of tax liability attributable to income of the year in which it is earned; receipts show the actual amount collected in the year in question. Since collection tends to lag behind the accruing of the liability, tax reductions show up in later years when shown on a "receipt" basis than when shown on a "liability" basis.

It is important to note that it is not expected that actual tax revenues in the fiscal year 1964 and future years will be reduced by the full $1.9 or $8.4 billion referred to above. It is anticipated that income levels in these years will be substantially higher as a result of the economic stimulus of the tax cut and will generate revenues significantly offsetting the budgetary impact of these rate reductions.

The stimulative effects of the tax reduction are expected to produce, according to the Treasury Department, relatively modest amounts of increased income in the first months, with the result that the "feedback" effect on the fiscal year 1964 revenues is expected to amount to only $200 million. As a result, the gross tax loss of $1.9 billion for the fiscal year 1964 is expected to be reduced to $1.5 billion after the "feedback" effect. The Treasury Department has estimated that the increased revenues from the rise of income, however, will amount to about $4 billion in the fiscal year 1965. Thus, the Treasury estimates that while tax reductions during that year would lose an estimated $8.4 billion of revenue at 1963 income levels, the net cost after allowing for the revenues generated by the expansion in income and

profits induced by the tax program would be limited to approximately $4.3 billion. The expansionary effect of the tax reductions on future years' revenues can be expected to be considerably larger than for the first 2 years. The order of magnitude was indicated in the discussion in part II.

Part A of table 3 shows by adjusted gross income class the distribution of changes in estimated tax liabilities for individuals when your committee's bill is fully effective. This table shows this distribution for each of the major rate and structural changes. These data are shown both in terms of amount of tax liability involved and the percentage change each of these is of present tax liability. It indicates that the rate changes alone would decrease tax liability by 20 percent while the structural changes would increase tax liability by 0.3 percent, resulting in the net reduction of 19.7 percent. Part B of table 3 presents similar data under the House bill.

Table 4 compares the tax liability effect of your committee's amendments with the House bill. This table indicates that in the calendar year 1964 your committee's amendments would decrease tax liabilities $680 million more than the House bill, in 1965 your committee's amendments are expected to decrease tax liabilities $395 million more and in the long run $185 million more.

The impact of the capital gains provisions is excluded from table 3 because of the difficulty of showing these changes by adjusted gross income class. Part A of table 1 sets forth the overall effect of the changes in the taxation of capital gains under your committee's bill: an increase of $115 million in calendar year 1964 tax liabilities, $120 million in 1965, and $50 million in the long run.[1]

As set forth in part A of table 2, the estimated overall revenue loss, before taking into account acceleration of corporation tax payments, is $2.2 billion in fiscal year 1964. This is $400 million less than was estimated in the budget. According to the Treasury Department this difference is due to the assumption of an earlier effective date in the budget document for institution of the 14-percent withholding. Similarly, according to the Treasury Department, the $9.3 billion revenue loss ($8.4 billion plus $900 million of accelerated corporation tax payments) estimated in part A of table 2 for fiscal year 1965 is greater than the loss shown in the budget by approximately $1.1 billion. The difference is ascribed primarily to $400 million due to the change in date of the reduced withholding and to the $680 million due to changes in structural provisions as shown in table 4.

[1] When this $115 million estimate for 1964 under your committee's bill is compared with the $295 million estimate under the House bill (pt. B of table 1) as subsequently revised to $215 million, the effect of your committee's action as compared to action by the House is a decrease in tax liability of $100 million in calendar year 1964 (see line 7 of table 4). Similarly, when the $120 million estimated increase in calendar year 1965 tax liabilities under your committee's bill is compared with the $170 million estimate under the House bill (pt. B of table 1), as subsequently revised to $80 million, the effect of your committee's action as compared to action by the House is an increase in tax liability of $40 million (see line 7 of table 4).

TABLE 1.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in tax liability* [1] (−) *and increase* (+) (*before feedback*) *of provisions of bill*

[In millions of dollars]

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

	Calendar year 1964 liability			Calendar year 1965 liability			Long run liability		
	Individual	Corporate	Total	Individual	Corporate	Total	Individual	Corporate	Total
A. Tax program:									
Rate changes: Basic rates	−6,310	−1,320	−7,630	−9,470	−2,190	−11,660	−9,470	−2,190	−11,660
Structural changes:									
(*a*) Revenue raising:									
1. Group term insurance	(2)		(2)	(2)		(2)	(2)		(2)
2. Bank loan insurance	+5		+5	+5		+5	+10		+10
3. Sick pay inclusion	+110		+110	+110		+110	+110		+110
4. Deduction of personal taxes	+190		+190	+190		+190	+190		+190
5. Casualty loss deduction	+50		+50	+50		+50	+50		+50
6. Aggregation of mineral properties		+40	+40		+40	+40		+40	+40
7. Personal holding companies	+15		+15	+15		+15	+15		+15
8. Repeal of dividend credit and increase in exclusion	+120		+120	+300		+300	+300		+300
9. Multiple corporation provisions		+30	+30		+30	+30		+30	+30
Total, revenue raising	+490	+70	+560	+670	+70	+740	+675	+70	+745
(*b*) Revenue reducing:									
10. Medical expense deduction	−10		−10	−10		−10	−10		−10
11. Child care allowance	−20		−20	−20		−20	−20		−20
12. Moving expenses	−105		−105	−105		−105	−105		−105
13. Income averaging	−40		−40	−40		−40	−40		−40
14. Minimum standard deduction	−320		−320	−320		−320	−320		−320
15. Repeal 2-percent tax on consolidated returns		−50	−50		−50	−50		−50	−50
16. Political contributions	−25		−25	−5		−5	−15		−15
17. Travel expenses	−5		−5	−5		−5	−5		−5
18. Installment sales treatment		[3] −140	−140		−10	−10		−10	−10
19. Expropriation loss carryover		(2)	(2)		−5	−5		−5	−5
20. Retirement income credit	−10		−10	−10		−10	−10		−10
Total, revenue reducing	−535	−190	−725	−515	−65	−580	−525	−65	−590
Total, structural changes	−45	−120	−165	+155	+5	+160	+150	+5	+155
Total, rate and structural changes, tax program	−6,355	−1,440	−7,795	−9,315	−2,185	−11,500	−9,320	−2,185	−11,505

Capital gains revisions (including induced effects):									
1. Unlocking of capital gains from general rate reduction	+130		+130	+130		+130	+50		+50
2. Sale or exchange of real estate		(2)	(2)		+5	+5		+15	+15
3. Sales of residences by taxpayers aged 65 or over	−10		−10	−10		−10	−10		−10
4. Capital gains treatment of iron ore royalties		−5	−5		−5	−5		−5	−5
Total, capital gains revisions	+120	−5	+115	+120	0	+120	+40	+10	+50
Total, tax program	−6, 235	−1, 445	−7, 680	−9, 195	−2, 185	−11, 380	−9, 280	−2, 175	−11, 455
B. Revision of 1962 legislation:									
1. Repeal of requirement to reduce basis by investment credit	−20	−140	[4] −160	−25	−170	[4] −195	−25	−170	−195
2. Allow investment credit for elevators and escalators		−10	−10		−10	−10		−10	−10
Total, revision of 1962 legislation	−20	−150	−170	−25	−180	−205	−25	−180	−205
C. Total, revenue bill of 1964	−6, 255	−1, 595	−7, 850	−9, 220	−2, 365	−11, 585	−9, 305	−2, 355	−11, 660

See footnotes at end of table

TABLE 1.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in tax liability* [1] (−) *and increase* (+) (*before feedback*) *of provisions of bill*—Continued

[In millions of dollars]

B. AS PASSED BY HOUSE OF REPRESENTATIVES

	Calendar year 1964 liability			Calendar year 1965 liability		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program:						
Rate changes	−6,310	−1,320	−7,630	−9,470	−2,190	−11,660
Structural changes:						
(*a*) Revenue raising:						
1. Group term insurance	+5		+5	+5		+5
2. Bank loan insurance	+5		+5	+5		+5
3. Sick pay exclusion	+110		+110	+110		+110
4. Deduction of personal taxes	+520		+520	+520		+520
5. Casualty loss deduction	+50		+50	+50		+50
6. Aggregation of mineral properties		+40	+40		+40	+40
7. Personal holding companies	+15		+15	+15		+15
8. Repeal of dividend credit and increase in exclusion	+120		+120	+300		+300
9. Multiple corporation provisions		+35	+35		+35	+35
Total, revenue raising	+825	+75	+900	+1,005	+75	+1,080
(*b*) Revenue reducing:						
10. Medical expense deduction	−10		−10	−10		−10
11. Child care allowance	−5		−5	−5		−5
12. Moving expenses	−60		−60	−60		−60
13. Income averaging	−40		−40	−40		−40
14. Minimum standard deduction	−320		−320	−320		−320
15. Repeal 2-percent tax on consolidated returns		−50	−50		−50	−50
Total, revenue reducing	−435	−50	−485	−435	−50	−485
Total, structural changes	+390	+25	+415	+570	+25	+595
Total, rate and structural changes, 1963 tax program	−5,920	−1,295	−7,215	−8,900	−2,165	−11,065

Capital gains revision (including induced effects):						
1. 50- to 40-percent inclusion [5]	+340		+340	+210		+210
2. Sale or exchange of real estate		(2)	(2)		+5	+5
3. Carryover of losses	−30		−30	−30		−30
4. Sales of residences by taxpayers aged 65 or over	−10		−10	−10		−10
5. Capital gains treatment of iron ore royalties		−5	−5		−5	−5
Total, capital gains revision	+300	−5	+295	+170	0	+170
Total, 1963 tax program	−5,620	−1,300	−6,920	−8,730	−2,165	−10,895
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit	−20	−125	[4] −145	−25	−160	[4] −185
2. Allow investment credit for elevators and escalators		−10	−10		−10	−10
Total, revision of 1962 legislation	−20	−135	−155	−25	−170	−195
C. Total	−5,640	−1,435	−7,075	−8,755	−2,335	−11,090

[1] At levels of income estimated for the calendar year 1963.
[2] Less than $2,500,000.
[3] Includes relatively small loss attributable to individuals.
[4] Treasury Department estimate; estimate of Staff of Joint Committee on Internal Revenue Taxation is $245,000,000 for 1964, and $305,000,000 for 1965.
[5] Includes amounts shown in part A as "unlocking due to general rate reduction."

TABLE 2.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in fiscal year receipts* [1] (−) *and increase* (+) (*before feedback*) *of provisions of bill*

[In millions of dollars]

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

	Fiscal year 1964 receipts			Fiscal year 1965 receipts		
	Individual	Corporation	Total	Individual	Corporation	Total
A. Tax program:						
Rate changes:						
Basic rates	[2] −2,200		−2,200	[2] −7,760	−1,320	−9,080
Acceleration of corporate payments		+260	+260		+900	+900
Total	−2,200	+260	−1,940	−7,760	−420	−8,180
Structural changes:						
(*a*) Revenue raising:						
1. Group term insurance				(3)		(3)
2. Bank loan insurance				+5		+5
3. Sick pay exclusion				+110		+110
4. Deduction of personal taxes				+190		+190
5. Casualty loss deduction				+50		+50
6. Aggregation of mineral properties					+40	+40
7. Personal holding companies				+15		+15
8. Repeal of dividend credit and increase in exclusion				+120		+120
9. Multiple corporation provisions					+30	+30
Total, revenue raising				+490	+70	+560
(*b*) Revenue reducing:						
10. Medical expense deduction				−10		−10
11. Child care allowance				−20		−20
12. Moving expenses				−105		−105
13. Income averaging				−40		−40
14. Minimum standard deduction				−320		−320
15. Repeal 2-percent tax on consolidated returns					−50	−50
16. Political contributions				−25		−25
17. Travel expenses				−5		−5
18. Installment sales treatment					[4] −140	−140
19. Expropriation loss carryover					(3)	(3)

20. Retirement income credit				−10		−10
Total, revenue reducing				−535	−190	−725
Total, structural changes				−45	−120	−165
Total, rate and structural changes, tax program	−2,200	+260	−1,940	−7,805	−540	−8,345
A. Capital gains revisions (including induced effects):						
1. Unlocking of capital gains from general rate reduction				+130		+130
2. Sale or exchange of real estate					(3)	(3)
3. Sales of residences by taxpayers aged 65 or over				−10		−10
4. Capital gains treatment of iron ore royalties					−5	−5
Total, capital gains revisions				+120	−5	+115
Total, tax program	−2,200	+260	−1,940	−7,685	−545	−8,230
B. Revision of 1962 legislation:						
1. Repeal of requirement to reduce basis by investment credit				−20	−140	[5] −160
2. Allow investment credit for elevators and escalators					−10	−10
Total, revision of 1962 legislation				−20	−150	−170
C. Total, revenue bill of 1964	−2,200	+260	−1,940	−7,705	−695	−8,400

See footnotes at end of table.

TABLE 2.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in fiscal year receipts* [1] *(—) and increase (+) (before feedback) of provisions of bill*—Continued

[In millions of dollars]

B. AS PASSED BY HOUSE OF REPRESENTATIVES

	Fiscal year 1964 receipts			Fiscal year 1965 receipts		
	Individual	Corporation	Total	Individual	Corporation	Total
A. 1963 tax program:						
Rate changes	−2,430		−2,430	−7,530	−1,320	−8,850
Acceleration of payments		+260	+260		+900	+900
Total	−2,430	+260	−2,170	−7,530	−420	−7,950
Structural changes:						
(*a*) Revenue raising:						
1. Group term insurance				+5		+5
2. Bank loan insurance				+5		+5
3. Sick pay exclusion				+110		+110
4. Deduction of personal taxes				+520		+520
5. Casualty loss deduction				+50		+50
6. Aggregation of mineral properties					+40	+40
7. Personal holding companies				+15		+15
8. Repeal of dividend credit and increase in exclusion				+120		+120
9. Multiple corporation provisions					+35	+35
Total, revenue raising				+825	+75	+900
(*b*) Revenue reducing:						
10. Medical expense deduction				−10		−10
11. Child care allowance				−5		−5
12. Moving expenses				−60		−60
13. Income averaging				−40		−40
14. Minimum standard deduction				−320		−320
15. Repeal 2-percent tax on consolidated returns					−50	−50
Total, revenue reducing				−435	−50	−485
Total structural changes				+390	+25	+415
Total rate and structural changes, 1963 tax program	−2,430	+260	−2,170	−7,140	−395	−7,535

Capital gains revision (including induced effects):						
1. 50 to 40 percent inclusion				+340		+340
2. Sale or exchange of real estate					(3)	(3)
3. Carryover of losses				−30		−30
4. Sales of residences by taxpayers aged 65 or over				−10		−10
5. Capital gains treatment of iron ore royalties					−5	−5
Total, capital gains revision				+300	−5	+295
Total, 1963 tax program	−2,430	+260	−2,170	−6,840	−400	−7,240
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit		−15	−15	−20	−125	[5]−145
2. Allowing investment credit for elevators and escalators		−5	−5		−10	−10
Total, revision of 1962 legislation		−20	−20	−20	−135	−155
C. Total	−2,430	+240	−2,190	−6,860	−535	−7,395

[1] At levels of income estimated for the calendar year 1963.
[2] Assumes effective date for withholding change of Feb. 22, 1964.
[3] Less than $2,500,000.
[4] Includes relatively small loss attributable to individuals.
[5] Treasury Department estimate; estimate of Staff of Joint Committee on Internal Revenue Taxation is $245,000,000.

TABLE 3.—*Revenue bill of 1964, H.R. 8363—Change in tax liability*[1] *resulting from rate and structural changes for individuals when fully effective*

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

Adjusted gross income class (thousands of dollars)	Rate change	Structural changes: Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Political contribution	Travel and entertainment	Retirement income credit expense	Total structural changes	Total rate and structural changes
	[In millions of dollars]																
0 to 3	−400	(2)	5	5	(2)	(2)	(2)	(2)	(2)	(2)		−170	(2)	(2)	(2)	−160	−560
3 to 5	−1,020	(2)	20	20	5	(2)	10	(2)	−10	−25		−100	(2)	(2)	(2)	−80	−1,100
5 to 10	−3,905	(2)	55	80	25	(2)	30	(2)	−10	−40	(2)	−50	(2)	(2)	−5	+85	−3,820
10 to 20	−2,285	(2)	25	45	15	(2)	50	(2)	(2)	−25	−10		(2)	−5	−5	+90	−2,195
20 to 50	−1,150	(2)	5	20	5	(2)	85	−5	(2)	−10	−20		−10	(2)	(2)	+70	−1,080
50 and over	−710	10	(2)	20	(2)	15	125	−5	(2)	−5	−10		−5	(2)	(2)	+145	−565
Total	−9,470	10	110	190	50	15	300	−10	−20	−105	−40	−320	−15	−5	−10	+150	−9,320

Adjusted gross income class (thousands of dollars)	Rate change	Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Political contribution	Travel and entertainment	Retirement income credit expense	Total structural changes	Total rate and structural changes
	Change as a percent of present tax																
0 to 3	−27.6	(2)	0.3	0.3	(2)	(2)	(2)	(2)	(2)	(2)		−11.7	(2)	(2)	(2)	−11.0	−38.6
3 to 5	−25.3	(2)	.5	.5	0.1	(2)	0.2	(2)	−0.2	−0.6		−2.5	(2)	(2)	(2)	−2.0	−27.3
5 to 10	−21.3	(2)	.3	.4	.1	(2)	.2	(2)	−.1	−.2	(2)	−.3	(2)	(2)	(2)	+.5	−20.9
10 to 20	−18.0	(2)	.2	.4	.1	(2)	.4	(2)	(2)	−.2	−0.1		(2)	(2)	(2)	+.7	−17.3
20 to 50	−17.0	(2)	.1	.3	.1	(2)	1.3	−0.1	(2)	−.1	−.3		−0.1	(2)	(2)	+1.0	−16.0
50 and over	−17.0	0.2	(2)	.5	(2)	0.4	3.0	−.1	(2)	−.1	−.2		−.1	(2)	(2)	+3.5	−13.5
Total	−20.0	(2)	.2	.4	.1	(2)	.6	(2)	(2)	−.2	−.1	.7	(2)	(2)	(2)	+.3	−19.7

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

Adjusted gross income class (thousands of dollars)	Rate change	Structural changes												Total
		Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Total	
	[In millions of dollars]													
0 to 3	−400	(2)	5	10	(2)	(2)	(2)	(2)	(2)	(2)		−170	−155	−555
3 to 5	−1,020	(2)	20	50	5	(2)	10	(2)	−5	−15		−100	−35	−1,055
5 to 10	−3,905	(2)	55	220	25	(2)	30	(2)	(2)	−25	(2)	−50	+255	−3,650
10 to 20	−2,285	(2)	25	130	15	(2)	50	(2)	(2)	−15	−10		+195	−2,090
20 to 50	−1,150	5	5	60	5	(2)	85	−5	(2)	−5	−20		+130	−1,020
50 and over	−710	10	(2)	50	(2)	15	125	−5	(2)	(2)	−10		+185	−525
Total	−9,470	15	110	520	50	15	300	−10	−5	−60	−40	−320	+575	−8,895
	Change as a percent of present tax													
0 to 3	−27.6	(2)	0.3	0.7	(2)	(2)	(2)	(2)	(2)	(2)		−11.7	−10.7	−38.3
3 to 5	−25.3	(2)	.5	1.2	0.1	(2)	0.2	(2)	−0.1	−0.4		−2.5	−.9	−26.2
5 to 10	−21.3	(2)	.3	1.2	.1	(2)	.2	(2)	(2)	−.1	(2)	−.3	+1.4	−19.9
10 to 20	−18.0	(2)	.2	1.0	.1	(2)	.4	(2)	(2)	−.1	−0.1		+1.5	−16.4
20 to 50	−17.0	0.1	.1	.9	.1	(2)	1.3	−0.1	(2)	−.1	−.3		+1.9	−15.1
50 and over	−17.0	.2	(2)	1.2	(2)	0.4	3.0	−.1	(2)	(2)	−.2		+4.4	−12.6
Total	−20.0	(2)	.2	1.1	.1	(2)	.6	(2)	(2)	−.1	−.1	−.7	+1.2	−18.8

[1] Excludes effect of capital gains provisions and repeal of the requirement to reduce basis by amount of investment credit.

[2] Less than $2,500,000 or 0.05 percent.

TABLE 4.—*Action by Senate Finance Committee on H.R. 8363 resulting in significant change in tax liability over House bill, calendar years 1964 and 1965 and long run*

[Millions]

	Change in tax liability from House bill		
	1964	1965	Long run
1. Deduction for political contributions	−$25	−$5	[1] −$15
2. Liberalized deduction for child care expense	−15	−15	−15
3. Elimination of allocation of travel expenses	−5	−5	−5
4. 100 percent intercorporate dividend deduction for certain affiliated groups	−5	−5	−5
5. Restoration of deduction of State and local gas tax and auto registration fees	−330	−330	−330
6. Allowance to reimbursed employee, as part of sales price, of selling costs and loss on forced sale of house	−45	−45	−45
7. Elimination of general capital gains provision	−100	+40	+260
8. Allowance of installment sales treatment for revolving credit plans	−140	−10	−10
9. Permitting election of 10-year carryforward without carryback for expropriation losses	([2])	−5	[2] −5
10. Increasing from $50,000 to $70,000 the minimum group-term life insurance subject to tax	−5	−5	−5
11. Liberalize retirement income credit on certain joint returns	−10	−10	−10
Total	−680	−395	−185

[1] $25,000,000 for presidential election year; 50 percent of that amount for congressional election year and 25 percent for off year; average about $15,000,000 per year.
[2] Less than $2,500,000 in 1964 and practically exhausted by 1970.

IV. GENERAL EXPLANATION

A. RATE CHANGES

1. *Individual income tax rates (sec. 111 of the bill and sec. 1 of the code)*

The most important change made by this bill is the individual income tax rate reduction. The bill, in both the House and your committee's versions, provides an individual income tax rate reduction of $9.47 billion spread over the 2 calendar years, 1964 and 1965. Over this 2-year period, the present rates, which range from 20 percent on the first $2,000 or $4,000 (the former for single persons and the latter for married couples) and 91 percent on incomes over $200,000 or $400,000 are reduced to a range of from 14 percent on the first $500 or $1,000 to 70 percent on incomes over $100,000 or $200,000. This represents an average rate reduction of 20 percent. Approximately two-thirds of this reduction is made effective in 1964 and the remaining one-third in 1965.

Table 5 shows the individual income tax rates under present law and under the House and committee bill, both for 1964 and for subsequent years. A separate table with rates, as nearly as possible halfway between those applicable for single persons and for married couples is provided for heads of households. The withholding tax rate of 18 percent under present law is reduced to 14 percent not only for 1965 and subsequent years but, under your committee's action also for 1964, starting 1 week after the date of enactment. The House bill would have provided a 15-percent rate for 1964. Wage bracket withholding tables provided by the bill reflect similar reductions in withholding tax rates. The 14-percent withholding tax rate is designed to withhold the appropriate amount of tax at an income level of $2,000 for a single person, or $4,000 in the case of a married couple, using the standard deduction.

TABLE 5.—*Individual income tax rates under present law and schedules provided by House and committee bill for 1964 and 1965*

Taxable income brackets (in thousands of dollars)		Present rates	Rates provided under House and committee bill—	
Single person	Married (joint)		1964 [1]	1965
		Percent	*Percent*	*Percent*
0 to 0.5	0 to 1	20	16.0	14
0.5 to 1	1 to 2	20	16.5	15
1 to 1.5	2 to 3	20	17.5	16
1.5 to 2	3 to 4	20	18.0	17
2 to 4	4 to 8	22	20.0	19
4 to 6	8 to 12	26	23.5	22
6 to 8	12 to 16	30	27.0	25
8 to 10	16 to 20	34	30.5	28
10 to 12	20 to 24	38	34.0	32
12 to 14	24 to 28	43	37.5	36
14 to 16	28 to 32	47	41.0	39
16 to 18	32 to 36	50	44.5	42
18 to 20	36 to 40	53	47.5	45
20 to 22	40 to 44	56	50.5	48
22 to 26	44 to 52	59	53.5	50
26 to 32	52 to 64	62	56.0	53
32 to 38	64 to 76	65	58.8	55
38 to 44	76 to 88	69	61.0	58
44 to 50	88 to 100	72	63.5	60
50 to 60	100 to 120	75	66.0	62
60 to 70	120 to 140	78	68.5	64
70 to 80	140 to 160	81	71.0	66
80 to 90	160 to 180	84	73.5	68
90 to 100	180 to 200	87	75.0	69
100 to 150	200 to 300	89	76.5	70
150 to 200	300 to 400	90	76.5	70
200 and over	400 and over	91	77.0	70

[1] Provides ¾ of tax cut in 1964.

The rate brackets provided by the House and committee bill differ from those under present law in that what is now the first bracket is divided into four brackets:

Single persons	*Married couples*
$0 to $500	$0 to $1,000
$500 to $1,000	$1,000 to $2,000
$1,000 to $1,500	$2,000 to $3,000
$1,500 to $2,000	$3,000 to $4,000

Splitting this first bracket into four brackets has several advantages. First, it makes it possible to have a lower starting rate than would otherwise be possible, given the same revenue loss. Only splitting this first bracket into four parts makes it possible to provide a 30-percent tax reduction for those with the lowest taxable income, who need the tax cut the most. Second, it makes it possible to provide some progression in the portion of the rate structure where none has been provided before. The significance of this is that over half of the taxpayers presently are subject only to the first bracket rate. As among taxpayers in this major group, the present rate structure provides no differentiation in applicable tax rates.

Table 6 shows the percentage of tax rate reduction provided in each rate bracket for 1965 and subsequent years. This table indicates that the new 14-percent rate represents a 30-percent reduction; the 15-percent rate, a 25-percent cut; and the 16-percent rate, a 20-percent cut. The average reduction in these first four brackets is 22.5 percent. Above this level the percentage reductions, up to a taxable income level of about $50,000 for single persons or $100,000 for married couples, is as nearly a uniform 15-percent rate reduction as practicable for a smooth progression. Above this $50,000 or $100,000 taxable income

level, the rate reductions again gradually increase until the top rate is reached at $200,000 or $400,000 where a 23-percent rate reduction is provided. This rate schedule, therefore, provides a minimum reduction of approximately 15 percent for all tax brackets. In addition, it provides extra reductions in the very lowest tax brackets where the impact of the present taxes is the most heavy. It also provides larger reductions in the very highest bracket where it is quite clear the present rates are too steeply graduated. These rates, which were developed during World War II to assure equality of sacrifice, are no longer appropriate under today's conditions.

TABLE 6.—*Individual income tax rates under present law and under House and committee bill for 1965*

Taxable income bracket (thousands of dollars)		Present law rate	House and committee bill		
Single person	Married (joint)		Rate for 1965 and subsequent years	Percentage reduction from present law rates	
		Percent	*Percent*	*Percent*	
0 to 0.5	0 to 1	20	14	30	
0.5 to 1	1 to 2	20	15	25	
1 to 1.5	2 to 3	20	16	20	22.5
1.5 to 2	3 to 4	20	17	15	
2 to 4	4 to 8	22	19	14	
4 to 6	8 to 12	26	22	15	
6 to 8	12 to 16	30	25	17	
8 to 10	16 to 20	34	28	18	
10 to 12	20 to 24	38	32	16	
12 to 14	24 to 28	43	36	16	
14 to 16	28 to 32	47	39	17	
16 to 18	32 to 36	50	42	16	
18 to 20	36 to 40	53	45	15	
20 to 22	40 to 44	56	48	14	
22 to 26	44 to 52	59	50	15	
26 to 32	52 to 64	62	53	15	
32 to 38	64 to 76	65	55	15	
38 to 44	76 to 88	69	58	16	
44 to 50	88 to 100	72	60	17	
50 to 60	100 to 120	75	62	17	
60 to 70	120 to 140	78	64	18	
70 to 80	140 to 160	81	66	19	
80 to 90	160 to 180	84	68	19	
90 to 100	180 to 200	87	69	21	
100 to 150	200 to 300	89	70	21	
150 to 200	300 to 400	90	70	22	
200 and over	400 and over	91	70	23	

The rate reductions found in table 6 reflect only the marginal rate reduction, or the rate reduction in each bracket. From the standpoint of the reduction in the total tax burden, however, it is important to realize that all taxpayers benefit from the rate reductions in all of the tax brackets below their top, or marginal, bracket. Thus, every taxpayer receives the benefit of the 30-percent reduction in the first bracket, either on his entire taxable income or on his first $500 or $1,000 of taxable income. Table 7 reflects this accumulative effect of the rate reduction provided by the House and committee bill. This is accomplished by showing for the top of each rate bracket—both for married couples and for single persons—the total tax under present law and under House and committee bill for 1965, together with the decrease, in terms of dollars and also percentages, which this represents in present tax liability. This indicates that on an accumulative basis the large rate reduction in the bottom bracket has an important effect on income up to $8,000 for married couples (or $4,000 for single per-

sons) and is of some significance for income levels up to about $40,000 for married couples (or $20,000 for single persons).

TABLE 7–A.—*Comparison of individual income tax liability under present law and under House and committee bill*

MARRIED COUPLE FILING JOINTLY

Amount of taxable income	Tax		Decrease in tax in House and committee bill	
	Present law	House and committee bill	Amount	Percent
$1,000	$200	$140	$60	30.0
$2,000	400	290	110	27.5
$3,000	600	450	150	25.0
$4,000	800	620	180	22.5
$8,000	1,680	1,380	300	17.9
$12,000	2,720	2,260	460	16.9
$16,000	3,920	3,260	660	16.8
$20,000	5,280	4,380	900	17.0
$24,000	6,800	5,660	1,140	16.8
$28,000	8,520	7,100	1,420	16.7
$32,000	10,400	8,660	1,740	16.7
$36,000	12,400	10,340	2,060	16.6
$40,000	14,520	12,140	2,380	16.4
$44,000	16,760	14,060	2,700	16.1
$52,000	21,480	18,060	3,420	15.9
$64,000	28,920	24,420	4,500	15.6
$76,000	36,720	31,020	5,700	15.5
$88,000	45,000	37,980	7,020	15.6
$100,000	53,640	45,180	8,460	15.8
$120,000	68,640	57,580	11,060	16.1
$140,000	84,240	70,380	13,860	16.5
$160,000	100,440	83,580	16,860	16.8
$180,000	117,240	97,180	20,060	17.1
$200,000	134,640	110,980	23,660	17.6
$300,000	223,640	180,980	42,660	19.1
$400,000	313,640	250,980	62,660	20.0

TABLE 7–B.—*Comparison of individual income tax liability under present law and under House and committee bill*

SINGLE PERSONS

Amount of taxable income	Tax		Decrease in tax in House and committee bill	
	Present law	House and committee bill	Amount	Percent
$500	$100	$70	$30	30.0
$1,000	200	145	55	27.5
$1,500	300	225	75	25.0
$2,000	400	310	90	22.5
$4,000	840	690	150	17.9
$6,000	1,360	1,130	230	16.9
$8,000	1,960	1,630	330	16.8
$10,000	2,640	2,190	450	17.0
$12,000	3,400	2,830	570	16.8
$14,000	4,260	3,550	710	16.7
$16,000	5,200	4,330	870	16.7
$18,000	6,200	5,170	1,030	16.6
$20,000	7,260	6,070	1,190	16.4
$22,000	8,380	7,030	1,350	16.1
$26,000	10,740	9,030	1,710	15.9
$32,000	14,460	12,210	2,250	15.6
$38,000	18,360	15,510	2,850	15.5
$44,000	22,500	18,990	3,510	15.6
$50,000	26,820	22,590	4,230	15.8
$60,000	34,320	28,790	5,530	16.1
$70,000	42,120	35,190	6,930	16.5
$80,000	50,220	41,790	8,430	16.8
$90,000	58,620	48,590	10,030	17.1
$100,000	67,320	55,490	11,830	17.6
$150,000	111,820	90,490	21,330	19.1
$200,000	156,820	125,490	31,330	20.0

Table 8 shows the distribution by adjusted gross income classes (as distinguished from taxable income classes) of both the rate and structural changes provided by the bill when these changes are fully effective. This table also shows the number of taxable returns and tax liability under present law (not including the alternative tax on capital gains), together with the tax liability which will remain when the rate reductions and other changes provided by this bill are fully effective. The table further shows the percentage distribution of the rate, structural, and total changes made by this bill (expressed as a percentage of present tax liability by income class). This indicates that the rate changes on the average represent a 20-percent reduction. The percentage reductions vary within the various income classes from 17 percent for adjusted gross income above $10,000 up to 27.6 percent for incomes below $3,000. Taking the structural changes into account, the overall reduction averages 19.7 percent under your committee's bill and 18.8 percent under the House bill. The reductions under your committee's bill range from 13.5 percent for those with incomes over $50,000 to 38.6 percent for those with incomes under $3,000. Under the House bill this range was from 12.6 to 38.3 percent.

TABLE 8.—*Revenue bill of 1964—Distribution by adjusted gross income class of the full year effect of all tax changes*[1] *made by your committee's bill which directly affect individuals*

Adjusted gross income class (thousands of dollars)	Number of taxable returns (millions)	Tax liability under present law[2]	Effect of revenue bill of 1964			Total tax under revenue bill of 1964
			Rate change	Structural changes	Total	
		In millions of dollars				
0 to 3	9.7	1,450	−400	−160	−560	890
3 to 5	10.5	4,030	−1,020	−80	−1,100	2,930
5 to 10	22.9	18,300	−3,905	+85	−3,820	14,480
10 to 20	6.7	12,710	−2,285	+90	−2,195	10,515
20 to 50	1.0	6,760	−1,150	+70	−1,080	5,680
50 and over	.2	4,170	−710	+145	−565	3,605
Total	51.0	47,420	−9,470	+150	−9,320	38,100
		Percent distribution by income class				
0 to 3	19.0	3.1	4.2	−106.7	6.0	2.3
3 to 5	20.6	8.5	10.8	−53.3	11.8	7.7
5 to 10	44.9	38.6	41.2	+56.7	41.0	38.0
10 to 20	13.1	26.8	24.1	+60.0	23.6	27.6
20 to 50	2.0	14.3	12.1	+46.7	11.6	14.9
50 and over	.4	8.8	7.5	+96.7	6.1	9.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
		Percent of tax liability under present law				
0 to 3		100.0	−27.6	−11.0	−38.6	61.4
3 to 5		100.0	−25.3	−2.0	−27.3	72.7
5 to 10		100.0	−21.3	+.5	−20.9	79.1
10 to 20		100.0	−18.0	+.7	−17.3	82.7
20 to 50		100.0	−17.0	+1.0	−16.0	84.0
50 and over		100.0	−17.0	+3.5	−13.5	86.5
Total		100.0	−20.0	+.3	−19.7	80.3

[1] Excluding effect of capital gains provisions and repeal of the requirement to reduce basis by amount of investment credit.
[2] Excludes alternative tax on capital gains.

The tax rate reductions described above take effect as of January 1, 1964, and January 1, 1965. For taxpayers with fiscal years falling partially in either the calendar year 1963 or the calendar year 1964, the bill provides for the proration of the rates applicable in the 2 years involved, according to the number of days in the fiscal year in question which falls in each calendar year.

The tax rate changes provided for individuals by this bill are expected to decrease tax liabilities in the calendar year 1964 by $6.3 billion and in the calendar year 1965 by $9.5 billion. The latter reduction is cumulative and includes the reduction of $6.3 billion for the calendar year 1964.

2. Minimum standard deduction (sec. 112 of the bill and sec. 141 of the code)

(*a*) *Present law.*—Under present law, single taxpayers who take the standard deduction, if they have no dependents, become taxable on income above $667. This represents a standard deduction of 10 percent ($67) plus the personal exemption ($600). For a married couple filing a joint return under present law, income becomes taxable above $1,333. This represents a 10-percent standard deduction ($133) plus two $600 exemptions. Similarly, a married couple with one child becomes taxable on income above $2,000 (a standard deduction of $200 plus three $600 exemptions).

(*b*) *General reasons for proposal.*—In addition to the rate reductions described above, the House and your committee concluded that it was desirable to remove from the tax rolls those persons with minimum incomes and also to provide those with incomes just slightly above these levels a somewhat larger tax reduction than is made available generally through the rate cuts.

The minimum standard deduction that the House and your committee have adopted, and which is described below, removes 1.5 million taxpayers, with very low incomes, from the tax rolls entirely.

The tax relief provided under this provision is almost entirely concentrated in the adjusted gross income classes of $5,000 or less, with much of it concentrated in income levels below $3,000. The total revenue loss anticipated from the minimum standard deduction of $320 million, for example, is distributed as follows:

Adjusted gross income class (thousands of dollars)	Change in tax liability from minimum standard deduction (millions of dollars)	Percentage change in present tax liability
0 to 3	−170	−11.7
3 to 5	−100	−2.5
5 to 10	−50	−.3
10 and over	0	0
Total	−320	−.7

The minimum standard deduction relieves persons at or near the subsistence level of much or all of their tax liability. In this respect the provision is much more economical than a personal exemption increase. The minimum standard deduction in the bill provides a floor of $300 above his exemption for a single person, a floor of $400

above exemptions for a married couple, and one of $600 above exemptions for a married couple with two children. Yet an increase in exemptions of only $100 would cost $2.6 billion, and one of $200 would cost $5 billion in lieu of the $320 million cost entailed in the minimum standard deduction.

(*c*) *General explanation of proposal.*—The bill provides that taxpayers who use the standard deduction may use either the regular 10-percent deduction or a minimum standard deduction, whichever is the larger. The minimum standard deduction in effect is $300 for the first exemption and $100 for each additional exemption. In the case of a married person filing a separate return, however, the minimum standard deduction is $200 for the first exemption and $100 for each additional exemption.[1] As under present law, the standard deduction, whether a "10-percent" deduction or a "minimum" deduction, may not exceed $1,000 (or $500 in the case of a married person filing a separate return).

Under the bill, a single person would be allowed a minimum standard deduction of $300 which, together with the personal exemption of $600, would mean that he would have no tax to pay until his income exceeded $900. Similarly, a married couple with no children would be allowed a minimum standard deduction of $400 ($300 for the first exemption, plus $100 for the second exemption). As a result, the married couple would pay tax on income only in excess of $1,600. A head of a household with one dependent also would be subject to tax only on income above $1,600, since the minimum standard deduction in this case also would be $300, plus $100 for the dependent. A married couple, both over age 65, would receive a minimum standard deduction of $600; i.e., $300 with respect to the first exemption, and $100 with respect to the three additional exemptions. This together with their four exemptions would mean they would pay no tax on the first $3,000 of income. This would also be true of blind persons with double exemptions.

The income levels under present law and under the bill at, or below, which there would be no tax, are as follows:

Status of taxpayer	Present law with 10-percent standard deduction	Minimum standard deduction provided by bill
Single person	[1] $667	$900
Married couple, no dependents or head of household, 1 dependent	[1] 1,333	1,600
Married couple, 1 dependent or head of household, 2 dependents	[1] 2,000	2,300
Married couple, 2 dependents or head of household, 3 dependents	[1] 2,667	3,000
Married couple, 3 dependents or head of household, 4 dependents	[1] 3,333	3,700
Married couple, 4 dependents or head of household, 5 dependents	[1] 4,000	4,400
Married couple, 5 dependents or head of household, 6 dependents	[1] 4,667	5,100
Married couple, 6 dependents or head of household, 7 dependents	5,333	5,800

[1] The amounts shown above assume that the income level under existing law is reached at exactly the level which would apply if a uniform 10 percent standard deduction were used. However, under present law for taxpayers with income below $5,000, a tax table with brackets is substituted for the uniform 10 percent. This modifies slightly all of the figures noted above. The income levels in these cases according to the tax table are $674, $1,324, $1,999, $2,674, $3,349, $3,999, and $4,649 respectively.

[1] In the case of married couples, where one takes the 10-percent standard deduction, rather than the minimum standard deduction, the other spouse must also take the 10-percent standard deduction. However, both may, if they so desire, elect to take the minimum standard deduction, which, as indicated above, is $200 for the 1st exemption and $100 for each additional exemption in the case of married persons filing separate returns.

Under the bill, taxpayers have the right to change their election with respect to the minimum standard deduction at any time within the period in which they can amend their tax return, that is, generally within the period ending 3 years after the due date filing for a given return.

(c)(i) *Effective date.*—Generally, the minimum standard deduction applies to taxable years ending after December 31, 1963. However, for taxpayers with fiscal years straddling this date, the bill provides for a portion of the benefits of the minimum standard deduction in the same way as rate reductions, in accordance with the number of days before and after December 31, 1963, in such years.

(d) *Revenue effect.*—The minimum standard deduction provided by this bill is expected to reduce revenues in a full year of operation by $320 million.

3. Amendments related to individual income tax rate reductions (sec. 113 of the bill and secs. 37 and 871 of the code)

(a) *Retirement income credit.*—Present law provides a tax credit on retirement for passive investment or pension income received by persons generally over age 65. However, the income taken into account for this credit must be reduced for tax exempt social security or railroad retirement income, and for those under age 72 for income derived from work above a specified income level. In computing the credit, present law provides that the income eligible for the credit is to be multiplied by the "rate provided in section 1 for the first $2,000 of taxable income." Under present law, this rate is 20 percent. Under both the House and committee bill, however, since this bracket has been split into four brackets, there are four rates ranging from 14 to 17 percent, applicable to different segments of this first $2,000 of taxable income.

The bill provides that the rate of tax to be used in computing this credit in the future is to be 15 percent. This is as near the middle of the four rates applicable to the first $2,000 of income as is possible, without the use of fractional rates.

(b) *Tax on nonresident aliens.*—Under present law, nonresident aliens receiving income from sources within the United States, such as interest, dividends, rents, salaries, wages, etc., are taxed on this income at a flat 30-percent rate (unless applicable tax treaties provide some other rates). However, present law also provides that if the nonresident alien receives more than $15,400 from the specified sources within the United States, then the regular individual income tax will apply with respect to the nonresident aliens' income from sources within the United States (if this results in a higher tax than the flat rate 30-percent tax).

The income level of $15,400 in present law is the point at which a 30-percent flat tax rate with one exemption would be likely to approximate the regular income tax rate with exemptions and with progressive rates. Because of the rate reductions provided by the bill, this income level of approximate equality rises, and has been established in the bill at $21,200.

4. Corporate rate reductions (sec. 121 of the bill and sec. 11 of the code)

Under present law, the total, or combined, corporate income tax rate is 52 percent. It consists of a 30-percent normal tax rate, applying to all corporate income, and a 22-percent surtax rate applying to corporate income in excess of $25,000. Thus, corporations are

taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on their taxable income above that level.

The House and committee bill makes two basic changes in the rate structure provided by present law. First, it lowers the overall rate from 52 to 50 percent for 1964, and to 48 percent for 1965 and subsequent years. Second, it "reverses" the normal and surtax rate in order to provide greater relief for small business. Thus, it provides that the normal tax rate is to be 22 percent instead of 30 percent for 1964 and subsequent years. The surtax rate then, for 1964, is to be 28 percent, and for 1965 and subsequent years, 26 percent. Thus, the bill provides a tax rate of 22 percent (in place of 30 percent) on the first $25,000 of a corporation's taxable income for both 1964 and subsequent years and a tax rate of 50 percent in 1964 and 48 percent in 1965 and subsequent years for the portion of a corporation's income over $25,000 (in lieu of the present 52-percent rate).

This reduction in corporate rates is important because it reverses the trend toward higher and higher corporate rates and also because it again makes the Government a "junior," rather than "senior," partner in any venture a corporation may undertake, insofar as the sharing of corporate income before tax is concerned. This tax rate reduction should be an important factor in improving the rate of profitability for corporations and, therefore, should provide an incentive for business investment and economic modernization and growth. It should also aid corporations in the export market in competing with corporations in other countries, where the corporate rates may not be as high as in the United States.

This tax cut for corporations, when fully effective, will amount to $2.2 billion a year. It should, of course, be viewed in connection with the reduction provided by Congress in 1962 in the form of an investment credit and the reform provided in 1962 in the depreciation guidelines. These taken together provide corporations with a tax reduction of approximately $4½ billion.

The "reversal" of the corporate rates should be a substantial benefit to small business. The substitution of a 22-percent rate for the 30-percent rate represents a rate reduction of nearly 27 percent on the first $25,000 of income, as contrasted to the rate reduction for income above $25,000 of slightly less than 8 percent. Moreover, as indicated in table 9, the benefit of this rate reduction on the first $25,000 of income is appreciable for income levels up to $100,000.

TABLE 9.—*Revenue effect* [1]

Surtax net income class (dollars)	Number of taxable corporations	Computed tax liability, present rates [2] (million)	Normal tax to 22 percent and combined rate to 48 percent	
			Amount of reduction (million)	Percent reduction
0 to 25,000	467,500	$874	$233	26.7
25,000 to 50,000	54,000	636	126	19.8
50,000 to 100,000	25,000	759	94	12.4
100,000 to 1,000,000	25,500	3,427	299	8.7
1,000,000 and over	4,000	18,664	1,438	7.7
Total	576,000	24,360	2,190	9.0

[1] At 1963 levels of income.
[2] Excluding capital gains presently taxed at the alternative rate.

Your committee agrees with the House that it is important to provide a greater rate reduction for small businesses because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion. As a result, they have traditionally found it necessary to expand largely out of income remaining after tax.

The rate reductions provided by the House and your committee for corporations apply to taxable years beginning after December 31, 1963, in the case of the reversal of the normal and surtax rates and also in the case of the reduction of the general rate to 50 percent. The reduction in the corporate rate from 50 to 48 percent applies to taxable years beginning after December 31, 1964. For fiscal year taxpayers, with years straddling either of these two dates, the bill provides that the reductions are to be prorated in accordance with the portion of the corporate year occurring after December 31, 1963, or after December 31, 1964.

The decrease of corporate rate from 52 to 50 percent in the calendar year 1964, and the reversal of the normal and surtax rates, is expected to decrease corporate tax liabilities for that year by $1.3 billion. The reduction in corporate tax liabilities for the calendar year 1965 and subsequent years (when the corporate rate will be further reduced to 48 percent) is expected to amount to $2.2 billion. This estimate is cumulative and includes the $1.3 billion loss referred to with respect to 1964 corporate tax liabilities.

5. *Current tax payments by corporations (sec. 122 of the bill and secs. 6074 and 6154 of the code)*

(*a*) *Present law.*—Under present law a calendar year corporation is required to pay 25 percent of its estimated tax in excess of $100,000 in the third quarter of the year in which the tax liability actually arises, or on September 15. Another one-fourth of this estimated tax is paid in the fourth quarter of the year of liability, or on December 15. The remainder of the tax is paid in two equal installments in the following year, the first installment being due at the same time as the tax return for that year, or on March 15, and the second and final installment being due on June 15. Comparable dates are provided for fiscal year corporations.

This system of paying two quarterly installments with respect to tax liability in excess of $100,000 in the same year in which the liability arises, was initially provided at the time of the adoption of the Internal Revenue Code of 1954. Before that time Congress had, in 1950, provided, in the case of calendar year corporations, that the tax was to be paid in two installments of 50 percent each on March 15 at the time for filing the return and on the following June 15, both of these payment dates being in the year immediately following the year in which the tax liability arose. (Comparable dates were provided for fiscal year corporations.) Prior to 1950, corporate taxes were payable in four installments of 25 percent each, the first two for calendar year corporations being on the dates specified above, and the last two on the following September 15 and December 15—both dates being in the year following the year in which the tax liability arose.

(*b*) *General reasons for provisions.*—As indicated above, corporations presently are only on a partial pay-as-you-go basis. Individuals, on

the other hand, either through withholding or through declarations, are on a full pay-as-you-go basis. Both the House and your committee, with respect to tax liability in excess of $100,000, place corporations on essentially the same pay-as-you-go basis as is already true in the case of individuals. This is to be accomplished gradually over a 7-year period. With the corporate rate reduction also provided by this bill, spreading the acceleration in corporate payments over this 7-year period can be accomplished without raising any corporation's income tax payment above its tax for 1963 (assuming the same income level throughout).

At the present time, the larger corporations appear to have sufficient funds to meet their investment requirements. In fact, many of the larger corporations customarily fund their tax liabilities by investing currently in Treasury tax notes or other types of short-term debt. Moreover, the cash and other liquid assets of corporations in 1962 amounted to $68.5 billion, or some five times the aggregate tax liability of these corporations. In any event, since in each year the acceleration in payments is offset or more than offset by the tax reduction, the speedup of corporate payments will not decrease internal funds available at the corporate level for investment. At the same time, the reduction in the rate of corporate tax will increase the profitability of investments, thus encouraging further expansion.

Since the acceleration of the corporate payments has no effect if tax liabilities are $100,000 or less, the smaller corporations which, in many cases, may have a shortage of internal funds available for investment, will not be affected by this provision. Such corporations will have additional funds available for investment through the general 4 percentage point corporate rate cut, and more especially through the 8 percentage point reduction in the tax applying to the first $25,000 of income.

(*c*) *General explanation of provision.*—Over the 7-year period, 1964 through 1970, the House and the committee bill, in effect, provides, in the case of calendar year corporations, that the two installment payments due on March 15 and June 15 of the year following the year of liability are to be advanced to April 15 and June 15 of the year of liability, leaving the September 15 and December 15 installment payments of 25 percent still due at the same time as under present law. (A comparable advance is made for fiscal year corporations.) Any liability, to the extent that it is not paid by estimated tax payments (for example, does not exceed $100,000), will still be payable in two installments after the close of the year of liability, on March 15 and June 15, in the same manner as under present law. The following tabulation shows the change in the percentage payment dates from present law to the system set forth in the bill when it is fully effective in 1970 and subsequent years:

	Percentage payments	
	Present law	Under bill when fully effective in 1970
Payments in year of liability:		
Apr. 15	0	25
June 15	0	25
Sept. 15	25	25
Dec. 15	25	25
Payments in year following year of liability:		
Mar. 15	25	(1)
June 15	25	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The advance in corporate payments described above is achieved under the bill over a 7-year period, commencing in 1964, with respect to tax liabilities arising in that year. For corporations with tax liabilities in excess of $100,000, the bill requires that they make first and second quarterly current payments of 1964 tax in excess of $100,000 of 1 percent in April and June of 1964 (assuming they are calendar year corporations), with these quarterly percentages increasing to 4 percent in 1965, 9 percent in 1966, 14 percent in 1967, 19 percent in 1968, 22 percent in 1969, and then 25 percent in 1970 and subsequent years. These percentages apply only with respect to the portion of the corporations' tax liabilities which exceed $100,000. This gradual shift of the corporate tax payments, with respect to tax liability above $100,000, can perhaps best be seen by the following tabulation.

	Percent of estimated tax to be paid on the 15th day of the—				Percent of tax to be paid on the 15th day of—	
	4th month	6th month	9th month	12th month	3d month	6th month
	of the year of liability				of the year following the year of liability	
1964	1	1	25	25	24	24
1965	4	4	25	25	21	21
1966	9	9	25	25	16	16
1967	14	14	25	25	11	11
1968	19	19	25	25	6	6
1969	22	22	25	25	3	3
1970 and any subsequent year	25	25	25	25	(1)	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The percentages of the tax liabilities to be accelerated for each of the years 1964 through 1970 were selected so that the speedup in corporate payments would not exceed the reduction in tax liabilities provided by the bill. The effect of the speedup on corporate tax liabilities for a calendar year corporation having a $10 million tax liability is shown in table 10. As indicated by this table, the combined effect of the rate reduction with the acceleration of corporate payments in all years results in a net reduction in tax payments, even for a corporation with a taxable income of $10 million. Corporations with smaller incomes would fare still more favorably in this respect.

The present provisions exempting corporations from any additional charges for failure to comply with the provisions of the declarations of estimated tax are continued as under present law. Present law provides an additional charge equal to 6 percent per annum for underpayments only if the estimated tax payments fail to come under one of the following four categories:

(1) they amount to 70 percent of the tax shown on the final return after subtracting $100,000 and allowing credits;

(2) they amount to as much as the previous year's tax reduced by $100,000;

(3) they are equal to what last year's tax (less $100,000 and allowable credits) would have been had current rates been applicable to that year's income; or

(4) the installment with respect to the declaration for any quarter is equal to 70 percent of the tax (less $100,000 and allowable credits) due on the basis of the income received to date, placed on an annual basis.

TABLE 10.—*Example of the combined effect on a calendar year corporation of current tax payments and the tax rate reductions provided by the bill (corporation assumed to have $10 million of taxable income and to base its estimates on 75 percent of this income* [1]*)*

Calendar year	Corporation payments		Calendar year	Corporation payments	
	Dollars	Percent of 1963		Dollars	Percent of 1963
1963	5,194,500	100.0	1968	5,145,513	99.1
1964	5,192,332	99.9	1969	5,004,707	96.3
1965	5,126,402	98.7	1970	5,004,707	96.3
1966	5,145,512	99.1	1971	4,793,500	92.3
1967	5,145,513	99.1			

[1] Your committee's bill provides for (1) a reduction of the normal tax rate to 22 percent in 1964; of surtax rate of 28 percent in 1964 and 26 percent in 1965; and (2) 1st and 2d quarter current payments in 1964 and 6 succeeding years of 1, 4, 9, 14, 19, 22, and 25 percent.

(*c*)(*i*) *Effective date.*—The changes described above with respect to the acceleration of corporate tax payments start in taxable years beginning after December 31, 1963, and will become fully effective for taxable years beginning after December 31, 1969.

(*d*) *Revenue effects.*—It has been estimated that this proposal will increase revenues in the fiscal year 1964 by $260 million and in the fiscal year 1965 by $900 million.

IV. GENERAL EXPLANATION

B. STRUCTURAL CHANGES

1. Dividend credit and exclusion (sec. 201 of the bill [1] *and secs. 34 and 116 of the code)*

(*a*) *Present law.*—Under present law, individuals are allowed to exclude from their tax base the first $50 of dividend income. If a husband and wife each have dividend income (or if they have such income jointly), the exclusion claimed on a joint return may amount to as much as $100 of dividend income. In addition, under present law, a credit of 4 percent is allowed against tax for any dividends

[1] The parenthetical references to the bill are to the bill as amended by your committee.

remaining after the $50 or $100 exclusion. This credit may not, however, exceed 4 percent of taxable income.[2]

(*b*) *General reasons for provision.*—In 1954 when the present dividend credit and exclusions were adopted, the committee report indicated that these relief measures were provided because the earnings of a corporation are taxed twice, once as corporate income and again as dividend income when paid out to the shareholders. It was stated that in addition to this being a double tax on this type of income, it also was a deterrent to investment in corporations. The report in 1954 partcularly stressed the effect of the penalty of double taxation in channeling investments in the form of indebtedness rather than equity capital or stock.

In fact, the reduction in the corporate rate by 4 percentage points provided by this bill probably does as much to remove any double taxation involved with respect to corporate distributions as would the continuance of the present 4 percent dividend credit. Moreover, from the standpoint of making funds available for investment in corporate enterprises, this reduction in tax with respect to retained earnings can be expected to have a more important impact on corporate investment than any reduction directed solely toward corporate income which is distributed. This greater encouragement for corporate investment has been provided not only by the corporate rate cut in this bill, but also by the investment credit allowed with respect to business investment in the Revenue Act of 1962. The House and your committee's action in this bill, in making this investment credit available without reduction in the depreciation base, provides still further inducements for business investment.

In addition, the notion that the dividend credit would encourage equity financing does not seem to be borne out by the events which have occurred since 1954. The Secretary of the Treasury has pointed out that the ratio of equity to debt financing by corporations has not increased despite the presence of the 4-percent credit.

The form of the present dividend credit, in any event, is undesirable since it reduces any double taxation by a much larger percentage for the higher income bracket stockholders than it does for those in the lower bracket. Information presented by the Secretary of the Treasury indicated that the dividend credit, even combined with the present exclusion, reduces the extra burden of double taxation by 10.4 percent in the highest income bracket, while reducing it by only 4.3 percent for those subject to the first bracket rate.

In view of these considerations, your committee agreed with the House that it would be better to concentrate relief from any double taxation which it is possible to provide in a dividend exclusion rather than in a dividend credit. The dividend exclusion, in the area operative, completely removes any double taxation. Moreover, increasing the exclusion, as the bill provides, will tend to encourage a broader stock ownership among those with relatively low income. At the same time, the repeal of the credit removes the discrimination in present law in favor of high bracket shareholders. Furthermore, removing the credit even though doubling the exemption available has the effect of raising $300 million of revenue in the calendar year

[2] The dividend exclusion and credit are not allowed for dividends received from foreign corporations, China Trade Act corporations, exempt corporations, corporations deriving most of their income from U.S. possessions, real estate investment trusts, life insurance dividends, dividends from mutual savings banks, domestic building and loan associations, etc., and capital gains dividends from regulated investment companies.

1965 and subsequent years, which in the bill is devoted to further individual income tax rate reductions than would otherwise be possible.

(c) *General explanation of provision.*—In view of the considerations referred to above, the bill, both as passed by the House and as approved by your committee, decreases from 4 to 2 percent the credit against tax allowed for dividends received during the calendar year 1964. With respect to dividends received in 1965 and subsequent years, the credit is repealed altogether. Consistent with the treatment provided when the tax credit was 4 percent of the dividend income, the dividend credit allowable during the calendar year 1964 is to be limited to 2 percent of taxable income received by an individual during that year.

The bill provides that with respect to dividends received in the calendar year 1964 and subsequent years the maximum exclusion per individual with respect to dividends received from a domestic corporation is to be $100, in lieu of the $50 available at the present time. In the case of married couples, where each owns stock separately or where stock is owned jointly and joint returns are filed, the maximum exclusion will be $200 in place of the $100 applicable under present law.

(c)(i) *Effective date.*—As indicated above, the dividend credit is reduced from 4 percent to 2 percent with respect to dividends received in the calendar year 1964 and is repealed with respect to dividends received in 1965 and subsequent years. The dividend exclusion is doubled with respect to amounts received in the calendar year 1964 and subsequent years.

(d) *Revenue effect.*—The combined effect of the reduction and then repeal of the credit and the increase of the exclusion is expected to increase tax liabilities by about $120 million for the calendar year 1964 and by $300 million in the calendar year 1965 and subsequent years when the repeal of the credit becomes fully effective.

2. Limitation on retirement income (sec. 202 of the bill and sec. 37 of the code)

(a) *Present law.*—Present law provides a retirement income credit which in general terms is designed to provide a credit against tax for those making provision for their retirement other than through social security, or railroad retirement or other tax-exempt income, and it is intended that this credit be approximately equal in value to the exclusions provided in the case of social security, etc. Thus, the maximum amount of income with respect to which a retirement income credit may be taken is geared to the maximum social security payment. Moreover, the credit is based upon the amount of pension or investment income of the individual involved, on the general principle that this represents the retirement base built up by those not covered by social security, etc. (or not covered to any appreciable extent). For the same reasons, the amount of income upon which the credit is based is reduced for any tax-exempt social security, railroad retirement, or other similar income received by the individual.

In addition, what amounts to a "work clause" applies to the retirement income credit to make it comparable to social security payments which also are reduced for earned income received by the individual above a specified level. The reduction for earned income in the case of the retirement income credit generally is a reduction of 50 percent for any earned income above $1,200 but not above $1,700, and a 100 percent reduction for any earned income above $1,700.

Social security and the retirement income credit also are correlated in the earnings requirement. To be covered for social security tax purposes, an individual generally must have a minimum coverage of 40 quarters or 10 years, assuming he has been in covered employment for a sufficient period of time. On the same basis, the retirement income credit provides that an individual to be eligible for the retirement income credit must have had 10 years of prior earnings experience, in each year of which he earned in excess of $600. For this requirement a widow or widower may use the earnings experience of the deceased spouse in much the same way as is provided in the case of social security benefits.

(*b*) *General reasons for provision.*—The attention of your committee was called to the fact that in one respect the retirement income credit is not coordinated with the social security program. Under the old age and survivors insurance program, if a husband has the appropriate 40 quarters of coverage but the wife does not, nevertheless, the payment may be made not only with respect to the husband directly but also a supplementary payment of one-half the size of the payment going to the husband may also be made with respect to the wife. The retirement income credit, on the other hand, contains no supplementary payment with respect to a spouse where that individual does not have the requisite prior 10 years' earnings experience. To provide a retirement income credit of one-half the size of that going to the primary wage earner in the family in such a case is the purpose of the amendment added by your committee.

(*c*) *General explanation of provision.*—Your committee has added a new subsection to the existing retirement income credit provision to provide that where the husband and wife have both attained the age of 65 before the close of the year, the maximum income on which the credit may be based is to be increased above the present ceiling of $1,524 by $762, or one-half of the present maximum. This is designed as the equivalent of the supplementary benefit going to a wife under the old age and survivors insurance program.

Where only one spouse has the requisite 10 years' prior earnings experience and receives an increase in his retirement income of $762, this amount is to be reduced by any social security, railroad retirement, or other tax-exempt pension income received by the spouse without the prior earnings experience. In addition, this $762 is to be decreased by any earned income this spouse is currently receiving in excess of $1,200 (on a 50-percent basis with respect to income between $1,200 and $1,700) assuming this spouse has not reached the age of 72.

If one spouse does not have 10 years' prior earnings experience, then the maximum base retirement income of the other spouse is increased by the full $762 (with certain reductions referred to later). On the other hand, if both husband and wife have the requisite 10 years' prior earnings experience and if one of them has less than $762 of retirement income, then the maximum of $1,524 with respect to the other spouse is to be increased to the extent that the retirement income of the other spouse is less than $762. Computations, similar to the reductions referred to above where only one spouse has the ten years prior earnings experience, are required here with respect to tax-exempt income and earnings above the specified levels.

It should be noted that increasing a spouse's maximum allowable retirement income by the $762, or any part of this amount, does

not of necessity mean a larger retirement income credit. Whether he can receive a larger retirement income credit in such a case depends upon whether or not he receives sufficient qualifying investment and/or pension income to reach this new ceiling level, which may be as high as $2,286. The credit allowable is 15 percent of this amount.

(c)(i) *Effective date.*—This increase in the retirement income credit applies to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—It is anticipated that this will result in an annual revenue loss of $10 million a year.

3. Investment credit: Repeal of provision reducing basis of property by 7 percent and other amendments (sec. 203 of the bill and secs. 48 and 1245 of the code)

(a) *Present law.*—Last year in enacting an investment credit, Congress in general allowed a credit equal to 7 percent of certain types of investment (3 percent in effect in the case of most public utilities). This amount may be offset in full against tax liability up to $25,000 and against one-quarter of the tax liability above this level. Property with an estimated useful life of 8 years or more is fully taken into account in computing this credit, property with an estimated life from 6 to 8 years is taken into account at two-thirds of its cost, while property with an estimated life from 4 years up to 6 years is taken into account at one-third of its cost. The credit for the most part is limited to purchases of tangible personal property. As a result, machinery and equipment are the principal types of investment eligible for the credit.

As finally enacted in the Revenue Act of 1962, it was further provided that the base on which depreciation may be taken in the case of assets eligible for the investment credit was to be reduced by the amount of the credit. Thus, for example, where a taxpayer purchased a $100 asset and $7 of this purchase price was allowed as an investment credit, the basis on which depreciation could be computed with respect to the asset was decreased from $100 to $93.

(b) *General reasons for provisions.*—Although the investment credit enacted last year appears to have been successful in stimulating investment, several problems have arisen with respect to this credit which are dealt with in this bill.

First and most important of the changes made is the repeal of the requirement that the basis of property eligible for the investment credit be reduced by 7 percent of the qualified investment. This provision requires that if property costing $100 and eligible for an investment credit of $7 was acquired, the basis of this property for purposes of depreciation (or gain or loss on sale) was to be reduced from $100 to $93.

This provision has proved troublesome to taxpayers since it requires a downward basis adjustment with respect to eligible property, whether or not an investment credit is claimed for the property. Moreover, making this adjustment has presented recordkeeping problems for taxpayers, especially in the case of early retirements, and also severely complicated the statutory language of the investment credit provision.

In addition, this basis adjustment for property severely restricted the incentive effect of the investment credit. In effect, this amendment converted the 7-percent credit into a 3½-percent credit for corporations, plus a 7-percent initial depreciation allowance. This

result occurs because the decrease in basis of the asset which may be written off means that the equivalent of approximately one-half of the investment credit is recouped over the life of the asset in substantially the same manner as an initial depreciation allowance. This effect substantially reduces the incentive effect of the credit, since it means that approximately half of the benefits must be restored over the useful life of the asset. In effect, this transforms one-half of the credit into an interest-free loan.

To remove the recordkeeping and accounting problems which have arisen in connection with the basis adjustment provision and also to provide a greater stimulus with respect to the investment credit, the bill, both as passed by the House and as reported by your committee, repeals this basis adjustment provision. It also provides a means whereby over a period of time taxpayers may recoup their basis adjustments already made.

A second problem presented with respect to the investment credit arises in determining the amount of the credit in certain situations in the case of leased property. Under present law a lessor may pass on the benefits of any investment credit with respect to his purchases or other acquisitions to the lessee of the property. This was provided on the grounds that it was the lessee in such cases who was creating the additional market for investment. The existing provision in this respect provides that the amount of the investment credit, if the property is constructed by the lessor, is to be the appropriate percentage of the "fair market value" of the property. However, in all other cases involving leases the investment credit is to be the appropriate percentage of the basis of the property to the lessor. In practice, this has discriminated in favor of manufacturers of equipment relative to independent distributors. Thus, in the case of equipment leased by the manufacturer having a fair market value of $1,000 the investment credit passed through to the lessee in this case will be 7 percent of $1,000 or $70. However, if the same equipment is purchased from the manufacturer by an independent distributor at a dealer's discount of perhaps 25 percent, the basis of the property to the dealer would be $750. Thus, he could pass on an investment credit of only $52.50 instead of the $70. As a result, it is more advantageous for customers to lease the property directly from manufacturers, rather than from independent distributors. Both the House and your committee's version of the bill removes this discrimination by basing the credit in both cases upon the fair market value of the property.

A third problem arises with respect to the treatment of escalators and elevators in the case of the investment credit. Among the categories of property not eligible for the investment credit are buildings and their structural components. Your committee's report indicated that the term "structural components" of a building included such parts of a building as central air conditioning and heating systems, plumbing and electric wiring and lighting fixtures relating to the operation and maintenance of the building. The proposed regulations issued by the Treasury Department with respect to the term "structural components" provide an extensive list of the type of items considered to be structural components and therefore not eligible for the investment credit. Among these items are escalators and elevators. While these regulations are an accurate interpretation of the intention of Congress last year in this respect, nevertheless your committee

agrees with the House that it is appropriate to reconsider the treatment of escalators and elevators for purposes of the investment credit. Escalators and elevators are closely akin to assets "accessory to the operation" of a business which presently are eligible for the investment credit. These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. In addition, new elevator and escalator equipment represents an important aspect of modernization of plant and facilities.

For the reasons cited above, the bill provides that new elevators and escalators installed after June 30, 1963, and modernization of existing elevators after that date should be eligible for the investment credit. This, of course, also means that elevators and escalators will be treated as coming under the recapture provision enacted in 1962. This in general provides that depreciation deductions taken with respect to such equipment in the future are to give rise to ordinary income to the extent of any gain recognized on the sale of such property.

A fourth modification in the investment credit relates to the treatment of the credit by regulatory bodies. Both the House and Senate committee reports on the investment credit, as well as the statement of the managers on the part of the House with respect to the conference (and the floor statement on the Senate with respect to the conference report) state that the purpose of the investment credit was to stimulate investment by reducing the net cost of acquiring depreciable assets. This is shown by the following quotations. First, in the report of the Committee on Ways and Means of the House on that bill:

> The investment credit will stimulate investments because—as a direct offset against the tax otherwise payable—it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment as it increases the expected return from their use. The investment credit will also encourage investment because it increases the funds available for investment. * * *

In the report of your committee on that bill it was stated:

> The investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. * * *
>
> The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment. It is your committee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy.

Again, in the statement of the managers on the part of the House with respect to the conference committee, and also in the floor statement of the manager of the bill in the Senate, it was stated:

> It is the understanding of the conferees on the part of both the House and Senate that the purpose of the credit for investment in certain depreciable property, in the case of both regulated and nonregulated industries, is to encourage mod-

ernization and expansion of the Nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of new facilities over their productive lives.

Despite the statements cited above, the Federal Communications Commission has indicated that it is its policy that any benefits from the investment credit made available by the Revenue Act of 1962 should "flow through" immediately to the customers. In addition, the staff of the Federal Power Commission has recommended the same position. This is clearly contrary to the intent of Congress in enacting this provision and as a result this bill contains a provision to the effect that it was and is not Congress' intention that the Federal regulatory agencies require the benefit of the investment credit to "flow through" in this manner.

(*c*) *General explanation of repeal of basis adjustment provision.*—In the case of property placed in service after December 31, 1963, the bill, as amended by your committee, repeals the provision in existing law requiring a downward adjustment in the basis of property by 7 percent of the qualified investment. In the House bill the repeal of the provision was for property placed in service after June 30, 1963. This date was moved up by your committee because of the later consideration of the bill by your committee.

In addition, the bill provides that the basis of property eligible for the investment credit which was placed in service before January 1, 1964 (July 1, 1963 under the House bill), is to be increased by 7 percent of the qualified investment for such property, as of the first day of the taxpayer's first taxable year beginning on or after that date—January 1, 1964, with respect to a calendar-year taxpayer.[1]

Where the lessor passed the benefit of the investment credit on to the lessee, present law provides that the deductions allowed to the lessee for payments to the lessor under the lease contract are to be adjusted downward to reflect an amount similar to the amount of basis denied in the case of other than lease property. The bill provides that where this has occurred the Treasury is to provide for upward adjustment in the deductions allowed to the lessee for amounts paid to the lessor to similarly reflect the restoration of basis adjustments in these cases.

The effect of the provisions described above is to provide for no downward adjustment in basis with respect to property placed in service after December 31, 1963 (June 30, 1963, under the House bill). With respect to property placed in service before that time but in 1962 or 1963 and still on hand at the beginning of the taxpayer's first year beginning after that time (January 1, 1964, in case of calendar-year taxpayers) the basis on which depreciation is taken (or gain or loss in the case of sale) for property which was eligible for the investment credit is to be increased by the same 7 percent by which the basis was reduced when the property was acquired. This addition to basis in the case of those computing depreciation on a straight-line basis will be recouped ratably by the taxpayer over the remaining life of the assets. In the case of double declining balance depreciation the recoupment will occur somewhat more rapidly. This method of handling the

[1] The restoration of basis referred to above is to be reduced with respect to any previous restoration which may have arisen because the property was no longer eligible for the investment credit or because of conversion of industrial property to public utility use, therefore no longer being eligible for the full investment credit.

restoration of the basis in the case of previously acquired investment credit assets makes the taxpayer "whole" without the necessity of refunds.

(c)(i) Credit for leased property to lessee.—As indicated above, present law provides that when the investment credit is passed through from the lessor to the lessee the investment credit is to be based on the fair market value of the property if the property was constructed by the lessor, but otherwise is to be determined from the basis of the property to the lessor. The House and your committee's bill provides that the investment credit in these lease cases is to be based on the fair market value of the property, whether or not the lessor created the property. An exception to this rule is provided, however, where the property is leased by a corporation which is a member of an affiliated group to another member of the same affiliated group. In this latter case, since there is no lease to an "outsider," the investment credit will still be determined on the basis of the cost of the property to the lessor. This amendment applies to property, the possession of which is transferred to a lessee on or after the date of enactment of this bill.

(c) (ii) Treatment of elevators and escalators. Elevators and escalators have not, up to this time, been eligible for the 7-percent investment credit, since they have been classified as structural components of a building which specifically were not eligible for the investment credit. Both the House and your committee's version of the bill, however, modifies this rule. It provides in the case of elevators and escalators that where their construction, reconstruction or erection is completed after June 30, 1963, or the elevator or escalator is new in the hands of the taxpayer and is acquired after that date, then the cost of the elevator or escalator (or a reconstruction) is to be eligible for the investment credit.

In view of the fact that the investment in elevators and escalators is to be eligible for the investment credit, they also are to be treated as subject to the recapture provision (sec. 1245) enacted by Congress in 1962. However, only depreciation deductions taken with respect to periods after June 30, 1963, are to be subject to this ordinary income recapture where the elevator or escalator subsequently is sold at a gain (and then only to the extent of this gain are these depreciation deductions to be treated as ordinary income). This provision applies only to elevators and escalators sold after December 31, 1963.

(c)(iii) Treatment of investment credit by Federal regulatory agencies.—Another investment credit provision in the bill makes it clear that it was the intent of Congress in providing an investment credit in 1962, and that it is the intent of Congress this year in repealing the reduction in basis required with respect to investment credit assets, to provide an incentive for the modernization and growth of private industry, including regulated industries.

As a result, the bill specifies in two paragraphs the intent of Congress as to the treatment of the investment credit by Federal regulatory agencies. It states in the case of public utility property that these regulatory agencies are not, without the taxpayer's consent, for the purpose of establishing the cost of service of the taxpayer, to treat more than a proportionate part of an investment credit (determined with reference to the useful life of the property) as reducing the taxpayer's Federal income tax liabilities. Nor are they to accomplish a

similar result by any other method. Public utility property for this purpose includes property of electric, gas, water, telephone, and telegraph public utilities which under present law is eligible for what in effect amounts to a credit of 3 percent.

The bill also provides restrictions for Federal regulatory agencies in the case of other regulated companies—such as natural gas pipelines, railroads, airlines, truck and bus operators, and other types of public carriers—which receive an investment credit of 7 percent of the investment in qualified property. It provides that Federal regulatory agencies are not, without the taxpayer's consent, for purposes of establishing the cost of service of the taxpayer, to treat any investment credit allowed him as reducing his Federal income taxes. Nor are the agencies to accomplish a similar result by any other method.

As indicated above in the case of the public utility property Congress is merely directing the Federal regulatory agencies not to "flow" the benefits of the investment credit "through" to the customers over any period shorter than the useful lives of the property involved. In the case of the other property Congress is directing the Federal regulatory agencies not to "flow" this benefit "through" at any time. This difference in treatment is attributable to the fact that Congress provided what in effect is a 3-percent credit for the public utility property rather than 7-percent credit because in 1962 it was recognized that in their case part of the benefit from the investment credit would be likely to be passed on eventually to the customers in lower rates.

(c)(iv) *Effective dates.*—As indicated previously, under your committee's amendments the repeal of the basis adjustment is to apply with respect to property placed in service after December 31, 1963. However, property placed in service before that time, with respect to which a basis adjustment has already been taken, if still in the hands of the taxpayer on the first day of his taxable year beginning after December 31, 1963, is to receive an upward adjustment in basis.

The amendment concerning the amount of the investment credit in the case of leased property is to apply with respect to property transferred to a lessee on or after the date of enactment of this bill. The amendment made with respect to escalators and elevators in the case of the investment credit applies to those acquired or constructed after June 30, 1963. The recapture rule with respect to these assets applies to dispositions of escalators or elevators after December 31, 1963.

(d) *Revenue effect.*—The repeal of the basis adjustment with respect to the investment credit is expected to reduce tax liabilities by $160 million in the calendar year 1964 and by $195 million in the calendar year 1965 with gradually greater reductions in successive years, according to Treasury estimates; estimates by the staff of the Joint Committee on Internal Revenue Taxation are $245 million and $305 million, respectively. Making elevators and escalators eligible for the investment credit is expected to result in an additional $10 million of loss in the calendar year 1964 and subsequent years.

4. Group term life insurance purchased for employees (sec. 204 of the bill and sec. 79 of the code)

(a) *Present law.*—Under present law, employees are required to include in their income the amount of premiums paid by their employers to provide them with individual life insurance or group

permanent life insurance which carries a loan or surrender value. However, the regulations (1.61–2(d)(2)) have provided that the cost of group term life insurance purchased for employees is not includible in their income as compensation although the employer receives deductions for the amounts he pays to provide this protection.

(b) *General reasons for provisions.*—As indicated above, this tax-free status for employer-financed group term life insurance is inconsistent with the tax treatment of other types of life insurance protection furnished employees by their employers. While this complete exclusion might have been considered relatively insignificant when tax rates were low, the present relatively high rates as well as the growing volume of group term life insurance now provided makes it particularly inequitable to continue this complete exclusion. The employee in such case receives a substantial economic benefit from this insurance protection whether or not the policy for a specific year leads to a payment to his beneficiary. The provision of this insurance by the employer relieves the employee of substantial costs of providing his own insurance protection for his family which he would otherwise have to provide out of tax-paid dollars.

The House, despite recognizing that the entire cost of this insurance protection represents compensation to the employee, provided an exemption with respect to the premiums paid on the first $30,000 of such insurance because it believed, from the standpoint of the economy as a whole, that it is desirable to encourage employers to provide life insurance protection for their employees. Provision of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely. Your committee is in accord with the reasoning of the House on this subject but believes that $70,000 represents a more appropriate exemption level. It has also made three other more technical amendments described below.

(c) *General explanation of provisions.*—For the reasons given above, the bill as amended by your committee provides that the gross income of an employee for tax purposes is to include the cost of any group term life insurance provided him under a policy carried directly or indirectly by his employer to the extent that the insurance coverage provided is in excess of $70,000 as contrasted to $30,000 under the House bill. The employee will not be charged with any portion of this insurance protection over $70,000 which he provides himself through his own contributions, since insurance protection provided in this manner is paid for out of tax-paid dollars. Moreover, all contributions made by the employee are applied against insurance protection above the $70,000 exclusion level.

The cost of protection above $70,000 is taxed to an employee if it is provided under a plan arranged for by the employer whether the protection the employee receives (over and above that provided by his own contributions) is provided directly by the employer, or indirectly by the employer's charging more than the cost of the insurance to other employees (such as those in younger age brackets) and less to those in the older age brackets, such as the specific employee in question.

(c)(*i*) *Exception for retired employees, etc.*—Both the House and your committee's bill provides an exception to the general rule described above where the individual's employment has been terminated and either he has reached the normal retirement age (under the practice followed by his employer) or he has become disabled. In both of

these cases it was concluded that it would be undesirable to tax the aged or disabled individual who is no longer working for group term life insurance protection provided to him by his former employer.

Two other exceptions are also provided where the insurance protection provided by the employer will not be treated as compensation to the employee, even though in excess of the $70,000 coverage exclusion. First, it will not be taxed to the employee where the employer directly or indirectly is the beneficiary of the policy since in such cases the employer is in reality providing for his own rather than his employee's interest.

Secondly, the costs of the insurance protection in excess of $70,000 will not be taxed to the employee where the beneficiary of the policy is a charitable organization (of the type described in sec. 170(c) of the code). An exception is provided for such cases because it is recognized that where an employer provides protection for all of his employees, a few of them may not have natural heirs and, therefore, if left to their own choice, might not purchase insurance protection. It was concluded that in such cases, it would be unfair to tax such employees on the cost of insurance protection provided by employers. For this reason, it was thought that where the employee demonstrated his own personal disinterest in the protection by naming a charity as the beneficiary, no portion of the cost of such protection should be considered as income to him. It is not intended, however, that he receive any deduction for a charitable contribution with respect to such assignment.

(c)(ii) Determining the cost of the insurance.—The House bill provided that the cost of the insurance protection can be determined under either of two methods. Your committee's bill provides that this cost can be determined only under the first of these methods. Under both versions of the bill this cost can be determined by using a uniform table. In this case, the cost of the insurance is averaged out on the basis of 5-year age brackets, in order to simplify computations which must be made by the employer in informing the employee as to the amount of taxable income. Where cost is determined on the basis of this uniform table it will be determined on the basis of a table published in the Treasury Regulations on this provision.

This table will reflect costs of such protection based upon insurance company experience and, of course, will be changed from time to time as mortality experience or other factors indicate that this is appropriate. Until provided otherwise by regulation, however, the cost per $1,000 of group term life insurance protection can be determined from table 11 below.

TABLE 11.—*Uniform 1-year term premiums for $1,000 of life insurance protection*

[Cost per $1,000 of protection]

Age:	
15 to 19	$1.44
20 to 24	1.73
25 to 29	2.11
30 to 34	2.72
35 to 39	3.65
40 to 44	5.10
45 to 49	7.36
50 to 54	10.87
55 to 59	16.29
60 to 64 [1]	24.67

[1] Those age 65 and over whose employment is not terminated will also have their insurance cost computed on the basis of the 60 to 64 age category.

The second method which would be available under the House bill but not under your committee's amendments provides that an employer, in computing the cost of his employee's protection for tax purposes, may use the actual cost of the policy to him and the employees. In this case also, the same 5-year age brackets as provided under the uniform premium table would be used. Your committee's amendments remove this second method of computation because it has been informed that this method is difficult for employers to compute. Moreover, since the uniform premium table method of computation contains no loading charge, in almost all cases it will in any event result in the lower cost.

Both the House and your committee's version of the bill provides that in the case of employees (not retired), who are over age 64, the cost of protection is not to be increased in such cases, but instead is to continue to be computed on the same basis as those in the age bracket 60 to 64.

(c)(iii) *Deduction for certain contributions provided by House bill but not your committee's amendments.*—The House bill provided a special deduction in computing taxable income for contributions made by an employee toward the purchase of group-term insurance protection in excess of the cost of his own insurance (only above the exemption level). This deduction was provided by the House bill on the grounds that under some group-term insurance plans the younger employees in effect pay for insurance protection provided for those in higher age brackets. It was suggested that this usually occurs where a uniform rate of contribution is required of all employees regardless of age. In such cases, it was indicated that the cost of protection for those who are relatively young may not equal the contribution made by the employees. In view of this, the House bill provided that contributions made by an employee (above the exemption level) to the extent that they exceeded the cost of the protection provided for him were to be deductible by him for tax purposes. Your committee's amendment deletes this deduction. Your committee has taken this action primarily because it believes that the size of these deductions would in any event be relatively small and on the grounds that it is questionable whether these deductions are worth the added administrative burden they would bring for the employer.

(c)(iv) *Example of method of computation.*—To illustrate the method of computing the taxable cost of group term insurance provided under your committee's version of the bill, it is first assumed that the employee makes no contribution toward this protection himself, and then that he makes a contribution of $2 per $1,000 of coverage. The method of computing the inclusion in the employee's gross income is illustrated by an employee age 41 who is provided with $200,000 of group term life insurance protection.

Where employee makes no contribution

Portion of insurance coverage taken into account ($200,000–$70,000)	$130, 000. 00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5. 10
Amount to be included in income tax base by employee ($5.10×130)	663. 00

Where employee makes contribution

Portion of insurance coverage taken into account ($200,000–$70,000)	$130, 000. 00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5. 10
Total cost of insurance attributable to employee's contribution ($2.00×200)	400. 00
Cost of insurance protection above $70,000 exclusion ($5.10×130)	663. 00
Amount to be included in income tax base by employee ($663–$400)	263. 00

(*c*)(*v*) *Reporting instead of withholding.*—The House bill provides that the cost of group term insurance, to the extent taxable to the employees, is to be subject to regular income tax withholding. Your committee concluded that this was unnecessarily burdensome for employers, particularly in view of the fact that so few employees would be affected by the $70,000 exclusion level. Instead, your committee's bill provides for the reporting of this income annually by the employer to the Government, with a copy of the information return also going to the employee. The amount shown on this information return is only the amount payable with respect to an employee which represents taxable income to him. Where he is covered by more than one employer, each employer is to determine the exemption for purposes of the information return in the same manner as if he were the only employer. The type of information return (form 1099) is the same as that already used under existing law to report dividends and interest. The penalties for failure to provide the information are $10 per person unless the failure is due to reasonable cause rather than willful neglect. The total penalties paid by an employer may not exceed $25,000.

(*c*)(*vi*) *Effective date.*—The tax treatment provided with respect to group term insurance as described above is to apply with respect to such insurance protection provided after December 31, 1963. The information reporting with respect to this insurance will apply to remuneration paid after December 31, 1963, in the form of group term insurance provided after that date.

(*d*) *Revenue effect.*—It has been estimated that the enactment of the group term life insurance provision described above will result in an increase of somewhat less than $5 million in revenues in a year when this provision is fully effective.

5. Sick pay exclusion (sec. 205 of the bill and sec. 105(d) of the code)

(*a*) *Present law.*—Under present law amounts paid to an employee by his employer to continue his wage payments when he is absent from work because he is sick or injured are excludable from the employee's gross income under certain conditions (although deductible by his employer). The exclusion in any case is available only up to $100 per week. In the case of absence from work due to personal injuries, this $100 is the only limitation at the present time. In the case of sickness, however, the exclusion is available only after the first 7 days of absence, unless the employee is hospitalized because of the sickness for at least 1 day during his absence.

(*b*) *General reasons for provision.*—Your committee agrees with the House that this sick pay exclusion in its present form is not justified. The amounts received by the employee in this case are substitutes for regular wages or salaries which, had they been received as such, would

be fully taxable. The wage substitutes in this case are wholly unrelated to the costs involved as a result of illness or injury. Amounts paid by the employer for the medical expense of the employee already are excludable by the employee under other provisions of law (sec. 105(b)) and amounts paid by the employee himself for medical expenses also are deductible elsewhere under present law (sec. 213 of the code) to the extent that they exceed what is considered to be the normal level of medical expenses.

The present exclusion also tends to encourage malingering because it treats the employee who stays at home better than another employee; also is easily abused because an employee who stays home because of a minor injury or illness may obtain an exclusion substantially in excess of any additional expenses he may incur.

The House bill provided, however, that those who have become permanently disabled or who have had long, continuing illnesses or accidents could continue to receive the advantage of this provision. It was thought that persons are likely to have their earnings substantially decreased, at the same time they also may be faced with large medical bills. Moreover, in such cases, the ordinary family financial requirements are likely to continue at their usual level, presenting larger problems for the individual as the period of absence from work becomes longer. Your committee also is in accord with this reasoning, and therefore has continued this provision unchanged.

(*c*) *General explanation.*—For the reasons presented above the sick pay exclusion of present law is amended to provide that wage continuation payments are not to be excludable to the extent they are attributable to the first 30 days of absence because of personal injury or sickness. This means, of course, that this exclusion will be available after the first 30 days of injury or sickness for the long continuing illness and also in the case of those receiving permanent disability pensions before the normal retirement age.

Under present law employers who make wage continuation payments which are not excludable from the employee's income (e.g., payments in excess of $100 a week or payments for the first 7 days in the case of sickness where there is no hospitalization) are required to include these amounts in income subject to withholding and reporting on form W–2. This practice will be continued under the revised provision with the withholding and reporting applying to a larger proportion of the wage continuation payments. Where these payments are made by someone other than the employer, such as an insurance company or a pension trust, the Treasury does not presently require withholding and it is the intention of the House and your committee that this practice be continued. However, these payments are (if made on behalf of the employer) to be included on the W–2 form prepared by the employer and shown on this form as wages or salary.

(*c*)(*i*) *Effective date.*—The amendment made by this provision will apply to wage payments attributable to periods of absence commencing after December 31, 1963.

(*d*) *Revenue effects.*—It is estimated that the provision described above, when fully effective, will result in an increase in revenues of $110 million a year.

6. Exclusion for gain on the sale of a residence by an individual age 65 or over (sec. 206 of the bill, sec. 121 of the code)

(*a*) *Present law.*—Under present law (sec. 1034) where an individual sells his old residence and, within a year of that sale, purchases a new residence (or within 18 months thereafter builds a new residence), the gain on the sale of the old residence is not recognized to the extent that it, plus the cost or other basis of the old residence, is invested in the new residence. This postponement of the taxation of the gain is available only where the new residence is purchased or built within the time specified.

(*b*) *General reasons for the provisions.*—While present law generally provides adequately for the younger individual who is for one reason or another changing residences, it does not do so for the elderly person whose family has grown and who no longer has need for the family homestead. Such an individual may desire to purchase a less expensive home or move to an apartment or to a rental property at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses. Nevertheless, under present law, such an individual must tie up all of his investment from the old residence in a new residence, if he is to avoid taxation on any of the gain which may be involved.

Your committee agrees with the House that this is an undesirable burden on our elderly taxpayers.

(*c*) *General explanation.*—For the reasons given above, the bill provides an exclusion from gross income for a limited amount of gain received from the sale or exchange of a personal residence in the case of taxpayers who have reached age 65 before the sale or exchange occurs. To be eligible for this treatment, they must have owned and used the property involved as their principal residence for 5 out of the last 8 years before the sale or exchange.

(*c*)(*i*) *Limitations.*—In this provision the primary concern is with the average and smaller homestead selling for $20,000 or less. For that reason, the application of this section is limited so that a full exclusion is provided only for the gain attributable to the first $20,000 of the sales price.[1] Where the sale price of the residence does not exceed $20,000, the entire gain is excluded from income for tax purposes. Where the sale price exceeds $20,000, a proportion of the gain is excluded. The proportion excluded is in the ratio of $20,000 to the actual sale price; for example, if a residence is sold for $60,000 and the gain is $10,000, then the portion of this $10,000 gain which will not be taxable is determined as follows:

Actual sale price	$60, 000
Ratio of $20,000 to sale price ($20,000/$60,000)	⅓
Proportion of $10,000 gain to be excluded from taxable income (⅓ of $10,000)	$3, 333. 33
Remaining gain subject to tax	$6, 666. 67

To prevent taxpayers over age 65 from reusing this section and obtaining numerous exclusions for gains on personal residences, the bill provides that this exclusion is available to a taxpayer and his spouse only once in their lifetimes.

[1] Actually the determination is made on the basis of adjusted sales price which as provided elsewhere in the code is the gross sales price less any so-called fix-up expenses incurred in selling the property. In this regard, see sec. 1034(b)(1).

(*c*)(*ii*) *Other rules.*—Since a taxpayer and his spouse may claim the exemption under this provision only once in their lifetimes, the bill provides that the exclusion is elective and may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of tax, generally about 3 years after the year of the sale or exchange. It also was necessary to provide a number of other special rules for the application of this provision. These rules may be described briefly as follows:

1. Where property is held jointly by a husband and wife either as joint tenants, tenants by the entirety or as community property, if a joint return is filed by the husband and wife and one of them satisfies the age requirement of 65 and has held and used the property for the required 5 out of the last 8 years, then both the husband and wife are treated as meeting these requirements.
2. Where the spouse of an individual has died and that spouse held and used the property as a personal residence for 5 out of the last 8 years and had not previously claimed an exemption under this provision, then the individual who is still living will be treated as satisfying these holding and use requirements. (However, the surviving spouse must be age 65 for the exclusion to apply).
3. The bill provides that for purposes of this provision tenant stockholders in a cooperative housing corporation who sell their right to occupy the house or apartment are to be treated in the same manner for purposes of this provision as those who own their residence outright.
4. Any gain realized from the destruction, theft, seizure, requisition, or condemnation of a personal residence is to be eligible for this provision in the same manner as if the residence had been sold.
5. Where a part of a property is used as a personal residence and the remainder as a business or income producing property, the exclusion provided under this provision upon the sale of the property is to be available to the extent that the gain is attributable to the portion of the property owned and used by the taxpayer as his personal residence.
6. In applying this provision, an individual is to be considered as married or single according to his status on the date of the sale or exchange. An individual who is separated under a decree of divorce or separate maintenance on the date of the sale is not considered as married for purposes of this provision.
7. In the case of involuntary conversions and in the case of the sale or exchange of one personal residence for another, gain is not recognized under present law where the total amount realized from the conversion or sale is reinvested within a specified period of time. In addition, the basis of the new property so acquired in such cases remains the same (except for any additional investments over and above the sales price) as the property previously held. Where both the exclusion available for taxpayers over age 65 and either of these two provisions may be applied with respect to the same transaction, the bill provides that the exclusion for those over age 65 is to be applied first. Thus, in the case of the involuntary conversion or the sale of a personal residence and the purchase of another, by a taxpayer who is over age 65, any gain which might be realized upon the involuntary conversion or sale of the residence will be reduced by any exclusion available to the taxpayer under this section. In addition, in the case

where the total amount is reinvested within the specified period the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence (and, of course, increased by any additional funds which he may have invested over and above the amount realized from the first residence).

8. In determining whether an individual has gross income of $600 or more (or $1,200 or more in the case of those over age 65) any exclusion provided under this provision will for that purpose alone be treated as gross income. This assures that the Government will receive proper reporting on amounts claimed as exclusions under this provision.

(*c*)(*iii*) *Effective date.*—This provision applies to sales, exchanges, and other dispositions after December 31, 1963.

(*d*) *Revenue effects.*—This provision is expected to result in an annual revenue loss of $10 million.

7. Denial of deduction for certain State, local, and foreign taxes (sec. 207 of the bill and secs. 164 and 275 of the code)

(*a*) *Present law.*—The general rule under present law is that taxes paid or accrued by a taxpayer are deductible for Federal income tax purposes. However, an exception to this rule provides that no deduction is to be allowed for certain specified taxes, principally Federal taxes. The categories of taxes which may not be deducted under present law are:

1. Federal income taxes.
2. Federal war profits and excess profits taxes.
3. Federal import duties and Federal excise and stamp taxes (except that these taxes may be deductible as business expenses or taken into account as expenses incurred in the production of income).
4. Estate, inheritance, gift, and similar taxes.
5. Most local improvement taxes.
6. Foreign income and excess profits taxes and similar taxes imposed by U.S. possessions (if the taxpayer elects to take a foreign tax credit for these taxes in lieu of a deduction).

The practical effect of the above listing of taxes is to deny any deduction for Federal taxes paid by the taxpayer (except to the extent that taxes listed in category 3 above qualify as business expenses or expenses incurred in the production of income).

State and local taxes on the other hand generally are deductible, except death and gift taxes and most local improvement taxes. The most important State and local taxes, and the revenues derived from them by State and local governments in 1961, are as follows:

1. Real and personal property taxes, $18 billion.
2. Income taxes, $3.9 billion.
3. General sales and gross receipts taxes, $5.4 billion.

The three categories of taxes indicated above account for $7.5 billion of the total $10 billion of taxes taken as nonbusiness deductions on taxable returns for Federal income tax purposes in 1960. The principal remaining State and local taxes, for which deductions may presently be taken, together with revenues derived from them by State and local governments in 1961, are as follows:

1. Gasoline taxes, $3.5 billion.
2. Auto and drivers' licenses, $1.8 billion.

3. Alcoholic beverage taxes, $0.7 billion.
4. Tobacco taxes, $1.1 billion.
5. Selective sales or excise taxes not included above (such as those on admissions, room occupancy, etc.), $1.8 billion.

(*b*) *General reasons for the provision.*—The House bill would provide for the continued deduction only of property taxes, income taxes, and general sales taxes. Your committee's amendments provide for the deduction of these three categories of taxes but also restores the deductibility of two categories of taxes which under the House bill would no longer be deductible. These are the excise tax on gasoline (and diesel and other motor fuels), and the taxes for auto registration and driver's licenses.

Your committee finds no disagreement with the House in the reasons given for the desirability of continuing the deductibility of property taxes, income taxes, and general sales taxes. In the case of property taxes, it was suggested that any denial of the deduction would result in an important shift in the distribution of Federal income taxes between homeowners and nonhomeowners. In the case of State and local income taxes, it was suggested that the continued deductibility of these taxes represent an important means of accommodation to take into account the fact that both State and local governments on one hand and the Federal Government on the other hand tap this same important revenue source. A failure to provide deductions in such a case could mean a combined burden of income taxes which in some cases would be extremely heavy. It was further indicated that, if property and income taxes are to be deductible for Federal income tax purposes, it also is important to allow the deduction of general sales taxes. To deny the deductibility of general sales taxes while allowing deductions for the other major revenue sources would encourage State and local governments to use these other resources in place of the sales tax. Your committee agrees with the House that it is important for the Federal Government to remain neutral as to the relative use made of these three forms of State and local taxation.

Your committee believes that much the same reasons which led to the House continuing the deduction of property, income, and sales taxes also suggest the desirability of continuing the deduction of gasoline and auto registration and drivers' licenses. Gasoline taxes are also a major source of State revenue and to deny the deduction of this tax while allowing the deduction of property, income, and general sales taxes tends to encourage States to use other than automotive taxes as their more important revenue sources. Moreover, a failure to provide a deduction for these automotive taxes also could result in an important shift in the distribution of Federal income taxes between classes of taxpayers, i.e., between those who own automobiles and those who do not.

Moreover, your committee is inclined to doubt that it is difficult for a taxpayer to make good estimates of the amount of these State and local automotive taxes as is sometimes suggested. The registration and drivers' license taxes are no more than annual taxes and certainly present the taxpayer with no particular recordkeeping problem. For most taxpayers the amount of gasoline taxes paid can be estimated relatively accurately either from credit sales slips or from the mileage added on a car each year.

Your committee agrees with the House that the other forms of excise taxes do present a recordkeeping problem for taxpayers. Also, it is recognized that these taxes, especially those on alcohol and tobacco products, may be deductible in some States and not in others, depending on the form of State law. As pointed out in the report of the House Committee on Ways and Means, in the case of cigarette and tobacco taxes, 26 States levy taxes which comply with the Federal rules for deductibility. However, 21 States and the District of Columbia have laws which do not meet these standards; and, thus, in these States, no deductions are available for these taxes.[1] There also is a wide variation among the States as to the deductibility of alcoholic beverage taxes. In six States, these taxes are imposed on the consumer and, therefore, are deductible. In addition, in 10 other States, where alcoholic beverages are sold through State liquor stores, the tax also generally is deductible.[2] This variation as to the Federal tax treatment of these various excise taxes is discriminatory as between taxpayers and different States. Moreover, it further complicates the already difficult problem of reporting deductible taxes in these cases. It should be noted, however, that this problem does not exist in the case of the gasoline, registration, and license taxes.

For the reasons indicated above, your committee is in agreement with the House as to the desirability of denying deductions in computing the Federal income tax for certain selective State and local taxes. However, in addition to retaining deductions for property, income and sales taxes, your committee has concluded that it also is desirable to retain deductions for gasoline and auto registration and driver's license taxes. Your committee has also made a modification with respect to limited types of improvement taxes which presently are deductible. As explained subsequently, under your committee's bill, such taxes to the extent now deductible will continue to be deductible.

(c) *General explanation of provision.*—For the reasons given above, your committee's bill provides as a general rule that only the following taxes may be taken as deductions:

1. State and local personal property taxes;
2. State and local, and foreign, real property taxes;
3. State and local, and foreign, income, war profits, and excess profits taxes; and
4. State and local general sales taxes;
5. State and local gasoline taxes (and taxes on diesel and other motor fuels);
6. State and local taxes on registering automobiles and on driver's licenses.

The fact that only these taxes may be deducted as taxes does not mean that other State, local, and foreign taxes may not be deducted to the extent they represent trade or business expenses or expenses incurred in the production of income. A sentence added to the code on this point makes it clear that these other State, local, and foreign taxes may be deducted as taxes when they are of a business nature or for the production of income even though otherwise they might have to be capitalized. Taxes levied on intangible personal property are examples of taxes generally deductible in this latter category since it

[1] Three States, Colorado, North Carolina, and Oregon, do not levy cigarette taxes.

[2] Seven States do not levy taxes on liquor except beer, and in some cases, wine. The beer and wine taxes of these States are not deductible.

can be reasonably supposed that the property subject to such a tax is held either in connection with a trade or business or for the current, or possible future, production of income.

(c)(i) Taxes which in no event may be deducted.—Under present law certain taxes, largely Federal taxes, may not be deducted in any case either as taxes or as business expenses or as expenses incurred in the production of income. To make clear the distinction between these taxes for which presently no deduction may be claimed and the other taxes which may be deducted if they represent expenses of a business or in the production of income, in the bill a new section (sec. 275) is added providing that no deduction at all may be taken for certain specified taxes. The taxes listed in this section are listed as exceptions in section 164 of the code under present law, and are moved to the new location in the code merely to emphasize the fact that these taxes cannot in any event be claimed as a deduction.

These taxes are as follows:

1. Federal income taxes;
2. Federal war profits and excess profits taxes; and
3. Estate, inheritance, legacy, succession, and gift taxes;
4. Income, war profits, and excess profits taxes imposed by a foreign country or a possession of the United States if the taxpayer chooses to take a foreign tax credit with respect to these taxes; and
5. Taxes on real property which the code requires to be treated as being imposed on another taxpayer.

Federal import duties and Federal excise and stamp taxes (to the extent not included in the above categories) will continue to be deductible to the extent they can presently be deducted as trade or business expenses (under sec. 162) or as expenses for the production of income (under sec. 212).

(c)(ii) Definitions of certain deductible taxes.—The bill defines a personal property tax which may be deducted as an ad valorem tax imposed on an annual basis in respect of personal property.

A general sales tax is defined as a tax imposed on one rate with respect to the sale at retail of a broad range of classes of items. The bill specifies, however, that the fact that food, clothing, medical supplies, and motor vehicles either are exempt from a sales tax or are taxed at a lower rate is not to result in any given tax being classified as not applying to a "broad range of classes of items." However, if any of these specified items are taxed at a higher rate than the general rate applying to other items, or if any other item is taxed at a different rate, no deduction is to be permitted for the tax on these items.

As under present law, deductions may be taken for general sales and gasoline taxes not only where they are imposed on the consumer as such, but also where they are separately stated and where the tax is in fact paid by the consumer.

Included in the definition of a deductible general sales tax by the bill is a "compensating use tax." A compensating use tax, as its name implies, is generally a tax imposed on items brought in from another taxing jurisdiction. In this case, the tax is imposed on the "use, storage, or consumption of the item" since the sale as such does not occur in the taxing jurisdiction in question. For such a tax to be deductible, similar items must be subject to a deductible general retail sales tax in the taxing jurisdiction in question.

(*c*)(*iii*) *Certain local improvement taxes.*—Under present law, local improvement taxes generally are not deductible (although interest or maintenance charges may otherwise be deductible). However, presently an exception is made and a deduction is permitted for local improvement taxes levied by a special taxing district where the district covers at least one entire county, at least 1,000 persons are subject to the tax levied by the district, and the district levies its assessment annually at a uniform rate on the same assessed value for real property as is used generally for purposes of the real property tax. The House would have eliminated this provision on the grounds that it is of limited application and also on the grounds that the continuation of this provision was not desirable. Your committee is in accord with the view that improvement taxes should not generally be deductible. However, in order to prevent the changing of rules of deductibility in this respect after debt has been incurred it has provided for the continued deduction of such taxes (to the extent presently deductible) for the purposes of paying off indebtedness already existing on December 31, 1963.

(*c*)(*iv*) *Effective date.*—The changes made by the above provisions relating to taxes apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—The changes made in the deduction of taxes by this section, as amended by your committee, are expected to increase revenues by $190 million in a full year of operation. The changes made by the House bill would have increased revenues by $520 million.

8. Personal casualty and theft losses (sec. 208 of the bill and sec. 165(c)(3) of the code)

(*a*) *Present law.*—Under present law, taxpayers may claim a deduction for losses of property not connected with a trade or business if these losses arise from fire, storm, shipwreck, or other casualty, or from theft. Under present law, these deductions are available without limitation to all taxpayers who itemize their personal deductions.

In addition, under present law, losses incurred in a taxpayer's trade or business or losses incurred in connection with transactions entered into for profit are deductible. The change made by this bill with respect to casualty losses described below does not affect the continued full deduction of these losses as business expenses or as expenses incurred in the production of income.

(*b*) *General reasons for provision.*—Your committee agrees with the House that in the case of nonbusiness casualty and theft losses, it is appropriate in computing taxable income to allow the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. In view of this, it is believed appropriate to limit the casualty loss deduction to those losses or thefts above a minimum amount. The minimum selected was $100 per casualty loss, since this corresponds approximately with the "$100 deductible" insurance carried by many individuals in the United States with respect to such losses. This means that no deduction will be allowed in the case of an ordinary "fender bending" accident or casualty, but that casualty and theft losses will continue to be deductible (over the $100) in those cases where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes.

(*c*) *General explanation of provision.*—The amendment made by both the House and your committee's versions of the bill limit the deductibility of personal losses (as distinct from those associated with a trade or business or transactions entered into for profit) to those where the casualty or theft loss exceeds $100. For this purpose, in determining what is a single casualty, it is intended that the law be interpreted liberally. Thus, for example, where an individual's property is damaged by wind from a hurricane and this is followed by additional damage resulting from water, it is intended that the combination of these events be treated as one casualty and, therefore, that all amounts over $100 of damage be deductible.

The $100 limitation applies to a joint return by a husband and wife as well as to a separate return of either. Thus, if a husband and wife file separate returns, each is subject to a separate $100 floor with respect to each casualty or theft, while, if they file a joint return, they are together subject to only one $100 floor with respect to each casualty or theft whether the loss is sustained with respect to jointly, or separately, owned property.

(*c*)(*i*) *Effective date.*—This amendment applies to losses sustained after December 31, 1963.

(*d*) *Revenue effect.*—It is estimated that this provision will increase revenues by $50 million a year in a full year of operation.

9. Charitable, etc., contributions, and gifts (sec. 209(a) of the bill and sec. 170(b) of the code)

(*a*) *Present law.*—Under present law, individuals are allowed a deduction of up to 20 percent of their adjusted gross income for contributions to or for the use of charitable, educational, religious, etc., organizations generally. An additional 10-percent deduction also is available for contributions to churches, schools, hospitals, certain medical research organizations, and certain organizations affiliated with State colleges or universities. Thus, with respect to contributions in this latter category, a charitable contribution deduction of up to 30 percent is allowed.

(*b*) *General reasons for provision.*—The House and your committee agree that the availability of this additional 10-percent deduction should be extended to include contributions to many forms of charitable or philanthropic organizations not now covered by this provision. Greater uniformity in the availability of this additional 10-percent deduction is desirable because of the many beneficial activities that are carried on by various philanthropic organizations not now eligible for the 30-percent deduction. This is especially true of many cultural and educational organizations and major charitable organizations not now eligible for the 30-percent deduction.

The additional 10-percent deduction is limited to organizations which are publicly or governmentally supported, however, and this additional deduction is not made available in the case of private foundations. These latter types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.

(*c*) *General explanation of provision.*—For the reasons given above, the House and your committee's bill provide that the additional 10-

percent deduction (or 30-percent deduction in total) from a taxpayer's adjusted gross income is to be extended so that it not only is available with respect to charitable contributions to churches, schools, hospitals, etc., but also is available generally in the case of charitable contributions to religious, charitable, scientific, literary, or educational organizations or those for the prevention of cruelty to children or animals (which otherwise meet the conditions set forth in sec. 170(c)(2) of the code). In addition, the 30-percent deduction is to be available for charitable contributions to a Federal, State, or local governmental unit if the contribution or gift is made for exclusively public purposes.

For any of the nongovernmental organizations to qualify for the additional 10-percent deduction referred to above, they must normally receive a substantial part of their support from a governmental unit or from direct or indirect contributions from the general public. "Support" for this purpose does not take into account income received by the organization from exercise of its exempt function. The reference to direct or indirect contributions from the general public prevents what are generally termed private foundations from qualifying for this additional 10-percent deduction. To qualify, the organization must receive support from at least a representative number of persons within the community concerned.

Types of organizations which generally will in the future qualify for this additional 10-percent deduction are those publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama, and organizations such as the American Red Cross, United Givers Fund, etc.

(c)(i) *Effective date.*—This provision applies to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—This amendment is expected to result in a negligible revenue loss when fully effective.

10. Denial of unlimited charitable contributions deduction with respect to gifts to private foundations (sec. 209(b) of the bill and sec. 170(b)(1)(D) of the code)

(a) *Present law.*—Under present law, the 30-percent limitation with respect to charitable contributions deductions in the case of individuals does not apply if the taxpayer in the taxable year in question and in 8 out of 10 of the preceding taxable years made a charitable contribution which taken together with his income taxes with respect to each of those years equalled 90 percent or more of his taxable income for the year in question. Under present law, there is no distinction between charitable contributions in the 20-percent category and those in the 30-percent category for purposes of this unlimited deduction. Thus, the charitable contributions taken into account both in the taxable year and in the 8 prior qualifying years can be either those to public type charities or those to private foundations.

(b) *General reasons for provision.*—Your committee has added a provision to the bill making the unlimited charitable contribution deduction available only with respect to contributions to publicly supported organizations for much of the same reasons that both the House and your committee only make the extra 10-percent deduction

available in the case of these organizations. Your committee believes that the special advantage of the unlimited charitable contribution deduction should not be made available in the case of these private foundations because frequently contributions to foundations do not find their way into operating philanthropic endeavors for extended periods of time. In the meanwhile, the funds are invested and the advantages arising from control of these investments are likely to inure to the principal contributors to the foundations. Thus, your committee concluded that if the 20- or 30-percent limitations with respect to charitable giving are to be removed for those desiring to make large contributions there should be no question that the bulk of the funds involved, within a reasonable period of time, are devoted to the charitable and philanthropic purposes.

(*c*) *General explanation of provision.*—Your committee's amendment provides that for taxable years beginning after December 31, 1963, the charitable contributions taken into account with respect to the unlimited charitable contributions deduction are to be only those going to publicly supported organizations. Moreover, if the unlimited charitable contributions deduction is elected by the taxpayer, then he is to receive no charitable contribution deduction for amounts going to organizations which are not publicly supported, such as private foundations (even with respect to contributions coming under the 20-percent test, which, without this provision, would allow such contributions).

Similarly, in determining in a subsequent year whether contributions and taxes in 1964 and subsequent years meet the 90-percent test in 8 out of 10 years, contributions to private foundations are not to be taken into account. However, with respect to any year prior to 1964 in determining whether charitable contributions and taxes equal 90 percent or more of the taxpayer's taxable income for purposes of the 8- out of 10-year test, charitable contributions to private foundations may be taken into account in the same manner as under prior law. Thus, for purposes of the unlimited charitable contribution deduction, your committee's bill follows the rules of prior law whenever any year prior to 1964 is taken into account and the new rules applicable with respect to any computation involving 1964 or a subsequent year. As a result taxpayers will not find the rules changed with respect to past years' computations; but, if they hope to obtain the benefits of the unlimited charitable contribution deduction with respect to the future, then for subsequent years they will have to forego any income tax benefits for contributions or gifts to private foundations.

With respect to future years, the unlimited charitable contribution deduction will take into account charitable contributions to: churches; schools; hospitals; specified medical research organizations; certain organizations affiliated with State colleges or universities; Federal, State, or local governmental units, if the contribution or gift is made for exclusively public purposes; and charitable contributions generally to religious, charitable, scientific, literary, or educational organizations or those for the prevention of cruelty to children or animals. However, in this latter case, the charitable organization must receive a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public. Support for this purpose does not take into account income received by the organization from the exercise of its exempt function. The reference

to direct or indirect contributions from the general public is designed to prevent gifts to private foundations from qualifying for this unlimited deduction. To qualify, the organization must receive support from at least a representative number of persons within the community concerned.

(c)(i) *Effective date.*—This provision applies to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—This amendment is expected to result in a negligible revenue increase.

11. Five-year charitable contributions carryover for individuals (sec. 209(c) of the bill and sec. 170(b)(5) of the code)

(a) *Present law.*—As indicated above, individuals are limited to a charitable contributions deduction of 20 percent of their adjusted gross income or up to 30 percent for contributions to churches, schools, hospitals, and contributions to public charities generally. Any charitable contributions in excess of the amount which may be deducted under these limitations in the current year in the case of individuals are wasted. Corporations, on the other hand, although limited to a charitable contributions deduction of 5 percent of taxable income (without this deduction) nevertheless may carry any unused charitable contribution deduction forward and under present law use them in the 2 following years. The House bill adds a provision which extends this carryover of unused charitable contributions for corporations to 5 years (see the discussion below).

(b) *General reasons for provision.*—Your committee has added a provision to the House bill to provide a 5-year carryover of unused charitable contributions for individuals. Your committee sees no reason why a carryover should be made available for corporations while individuals are in effect compelled to waste their contributions in excess of the specified limitation. More important, however, this will make it unnecessary for taxpayers desiring to make a contribution of a substantial nature to a charitable organization to carefully divide the gift into parts, contributing each in a separate year, or perhaps giving undivided interests in a property, up to their applicable limitation, to the charitable organization in each of a series of years. Not only is the present practice complicated for the donor but it also creates problems for the charitable or educational organization. Where they are given undivided interests in a property over an extended period of time, they may find it impossible either to sell or use the property over this same period of time while their interest in it gradually increases from year to year. The allowance of a 5-year charitable contribution carryover for individuals, like the averaging provision contained in this bill, also is another step toward the computation of income for tax purposes over a long period of time rather than on an annual basis.

(c) *General explanation of provision.*—For the reasons indicated above, your committee has added a provision to present law providing a 5-year carryforward for individuals for unused charitable contributions. In making this carryover available, your committee's amendments provide that the only amounts which may be carried forward are excess contributions with respect to which the 30-percent limitation applies (i.e., generally all contributions except those going to private foundations). In determining whether there is any unused charitable

contribution to carry forward, the charitable contributions to private foundations are ignored and only those contributions fully eligible under the 30-percent limitation, to the extent they exceed this limitation, may be carried forward.

In the year to which these contributions are carried, if the taxpayer has made any contributions to a private foundation, these are ignored for purposes of determining how much of these charitable contributions carried forward are used up in that year. This can be illustrated by the following example: Assume $500 of unused charitable contributions are carried forward, the individual's 30-percent limitation for the year in question would permit charitable contribution deductions of $1,000, and $400 had been already contributed in that year to private foundations and $300 to publicly supported charitable organizations. In this case the entire $500 carryforward would be considered as used up in that year, although the additional charitable contribution deductions obtained with respect to this $500 would be only $300. This result is obtained by ignoring the $400 of contributions to the private foundation for purposes of determining the extent to which the carryover is used up in that year. Thus, in the example cited, the charitable contribution in the year to publicly supported organizations was $300 and the carryover from the prior year was $500. This would make it possible to use up the entire charitable contribution carryover in that year. The individual could also deduct $200 of the $400 which he contributed to the private foundation. Since under existing law the individual in the example could have claimed a deduction of $700, the use of the carryover permits an additional deduction of $300.

The provision added by your committee also provides that no charitable contribution may be carried to, or through a year with respect to which the taxpayer has elected the unlimited charitable contributions deduction. The carryover was considered unnecessary in such cases because of the fact that no limitations are imposed in these cases. A technical adjustment is also made to prevent a taxpayer from claiming a benefit with respect to the same amount twice, through the interaction of the net operating loss carryover and the 5-year charitable contribution carryover.

(*c*)(*i*) *Effective date.*—The new 5-year charitable contributions carryover provided by your committee's bill will be available with respect to contributions paid in taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible revenue loss.

12. Five-year charitable contribution carryover for corporations (*sec. 209*(*d*) *of the bill and sec. 170*(*b*)(*2*) *of the code*)

(*a*) *Present law.*—Under present law corporations are allowed a maximum charitable contribution deduction of 5 percent of their taxable income computed without regard to this deduction (and certain other deductions). Any charitable contribution deductions which exceed this maximum may be carried forward and used in the 2 following years to the extent the maximum limitations for those years permit. In the case of tax-free reorganizations, generally, and in the case of the liquidation of a subsidiary, the present law provides that the 2-year charitable contribution carryover, to the extent not used by the prior corporation, is to be available to the acquiring corporation.

(*b*) *Reasons for provision.*—Situations have arisen where corporations have income which varies widely from year to year with the result that in some years they have losses and in other years income. This presents a problem where these corporations have committed themselves to the making of specific annual contributions to local charitable organizations. This frequently is done because of the importance to the local charity of maintaining a relatively stable budget from year to year. However, from the standpoint of the corporation the 5-percent limitation on charitable contributions means that the benefit of the charitable contribution deduction is lost in loss years, or in low income years, unless income is sufficiently high in the 2 immediately following years to not only permit the deduction of the amount carried forward but the usual charitable contributions for those years as well. Frequently this is not a sufficient length of time to enable the full deduction of charitable contributions in such cases.

(*c*) *General explanation of provision.*—In view of the above considerations the House bill substitutes for the 2-year carryforward of unused charitable contributions available in present law a 5-year charitable contribution carryforward for corporations. Your committee has accepted this amendment except that it has amended the effective date as indicated below. The amount which may be carried forward in such cases is the amount of the charitable contributions in excess of the amount which may be deducted within the 5-percent limitation. In the year to which the charitable contributions are carried the charitable contributions of that year are applied first, and then the charitable contributions carried forward with the oldest year from which a charitable contribution is carried forward being applied first. Any unused charitable contributions are carried forward to succeeding years, but if not used up after a 5-year carryforward period, they no longer are available for further deduction.

The 5-year charitable contribution deduction carryover is also made available to acquiring corporations in tax-free reorganizations and to parent corporations in the case of the liquidation of a subsidiary. The acquiring corporation in these cases treats the carryforward of the charitable contribution in the same manner as if it were its own unused charitable contribution being carried forward to the current year.

(*c*)(*i*) *Effective date.*—The 5-year carryforward under the House bill would be effective with respect to contributions paid (or treated as paid) in taxable years beginning after December 31, 1963. Thus, under the House bill a charitable contribution made in 1964 would be the first charitable contribution with respect to which the 5-year, as distinct from the 2-year, charitable contribution carryforward would be available. Under your committee's amendments, the 5-year carryforward of unused charitable contributions will be available with respect to contributions paid (or treated as paid) in taxable years beginning after December 31, 1961. Thus, charitable contributions made in the calendar years 1962 and 1963, (to the extent the former is not used in 1963) will be available as carryforwards to 1964, since in these cases the 2-year carryforward from these years has not yet expired.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue when fully effective.

13. Limitation on charitable contribution deduction for future gifts of tangible property (sec. 209(e) of the bill and sec. 170(f) of the code)

(*a*) *Present law.*—Under present law, if a taxpayer gives property to charity but retains for either his or someone else's life or any other period the use or enjoyment of the property, he receives a charitable contribution deduction for income tax purposes at the time of the gift of the future interest in an amount equal to the present discounted value of that future interest.

(*b*) *General reasons for provision.*—The House report calls attention to the problem where pictures or art objects are given to museums, but the gift takes effect at some future time, usually based upon the life of the contributor or someone else. In the meanwhile, the use of the pictures or art objects is retained in much the same manner as if the contribution of the future interest had not been made. The same enjoyment would occur, for example, if instead of making a gift of a future interest, the taxpayer were to wait until his, or his family's use of the property was completed. If this use was completed at the time of his death, however, no charitable contribution for income tax purposes could be claimed, even though an estate tax deduction would be available.

The report of the House Committee on Ways and Means suggests generally that it is inappropriate for taxpayers using this device to obtain what amounts to an extra charitable contribution deduction for income tax purposes. However, the House report further suggests that in the ordinary case where the contributor retains the right to use the property for his own life that this in fact has been a strong inducement for giving pictures and art objects to museums and other cultural centers in the United States and that in any event much of the problem which has arisen in the past has stemmed from the problem of valuing the pictures and art objects given.

Based upon the consideration outlined above, the House bill provided a general rule which denied deductions for charitable contributions in the form of future interests in tangible personal property, but then made this rule inapplicable where the life interest was retained for the life or lives of the contributor or contributors. Your committee is in agreement with the general rule adopted by the House but believes that the exception making this general rule inapplicable in the case where a life estate was retained by the contributors in effect makes this rule inapplicable to the bulk of the cases which should come under the rule. Your committee sees no more reason for granting a charitable contribution deduction for income tax purposes whether the life interest is reserved for the contributor or someone else. It recognizes that for some taxpayers this may have some temporary effect in dulling the special incentive now existing for giving pictures and art objects to museums and other cultural centers. Moreover, some taxpayers may be induced under this provision to give their pictures or other objects outright during life rather than wait until their death, thereby accelerating gifts to museums and other organizations. In any event, your committee questions whether it is appropriate to provide the special stimulus of an income tax deduction, in addition to a charitable deduction for estate tax purposes, to induce this result.

(*c*) *General explanation of provision.*—For the reasons indicated above your committee's amendments provide that charitable con-

tributions in the form of a future interest in tangible personal property are to be treated as deductible for income tax purposes only when all interests in, and rights to possession or enjoyment of, the property in question has been given up. Your committee has deleted the exception in the House bill making this rule inapplicable in the case of charitable contributions where the only reservation in the gift is that the property is not to be transferred until the death of the contributor or contributors.

Any type of a reservation by the contributor and any reservation in the hands of related persons described in section 267(b) of the code under your committee's action will result in a denial of the charitable contribution deduction as long as the reservations continue.

Although generally this provision is limited to gifts of future interests in tangible personal property the provision also covers fixtures which are intended to be severed from the real property, such as chandeliers, mantels, etc.

(*c*)(*i*) *Effective date.*—This provision applies to transfers after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible revenue gain when fully effective.

14. Losses arising from expropriation of property by governments of foreign countries (sec. 210 of the bill and sec. 172(b)(1)(D) of the code)

(*a*) *Present law.*—Generally, under present law, a net operating loss may be carried back to each of the 3 prior years and then, to the extent of any loss still not offset against income, the balance may be carried forward to the 5 succeeding years—providing a period of 8 years over which a loss may be spread. In two cases under present law, however, longer loss carryover periods are provided. Thus, in the case of corporation suffering losses which are certified as arising with respect to the "Trade Expansion Act of 1962", a 10-year carryover period is provided—a 5-year carryback and a 5-year carryforward. Present law also provides a 10-year carryover period in the case of regulated transportation companies—in this case a 3-year carryback and a 7-year carryforward.

(*b*) *General reasons for provision.*—Your committee has been informed that since World War II at least 14 foreign governments have expropriated property of U.S. taxpayers. The most significant of these expropriations was that made in Cuba, beginning in 1959 when all U.S. investments in that country were expropriated by the government.

Generally, it is believed that the 3-year carryback and 5-year carryforward for net operating losses provide a sufficient period for the recovering of substantially all business losses. In those cases, however, where this period has proved insufficient, Congress has followed the policy of providing a longer loss-carryover period. This accounts for the 10-year period in present law for those suffering losses arising under the Trade Expansion Act of 1962 and for the 10-year period in the case of regulated transportation companies.

Your committee believes that the expropriations by foreign governments which have occurred in recent years represent another example of larger than usual losses, where the usual 8-year carryover period for losses is inadequate. Therefore, your committee's amendments

extend the 10-year loss period, already applied in special cases, to expropriation losses. A 10-year carryforward with no carryback is provided for these expropriation losses. The longer carryforward has been substituted for the 3-year carryback because, if carrybacks were required, the taxpayers might have to forego the benefits derived from using foreign taxes as credits rather than deductions with respect to the back years.

(c) *General explanation of provision.*—Your committee's amendment provides a 10-year carryforward with no carryback for expropriation losses. This is available with respect to expropriation losses arising in taxable years ending after December 31, 1958. Thus, it will include 1959 which was the year the Cuban expropriations began.

To qualify for the 10-year carryforward, the expropriation loss must be at least 50 percent of the total net operating loss for a year. Thus, this extra carryforward period will not be available unless the expropriation loss is a major proportion of a company's net operating loss.

To receive this treatment, the taxpayer must elect the 10-year carryforward on or before the time specified by regulations prescribed by the Secretary of the Treasury or his delegate. However, in the case of past years with respect to which the 10-year carryforward is to be available, namely the years 1959 through 1963, taxpayers are to have until December 31, 1965, to make the elections for these years. In these cases the statute of limitations will be opened for deficiencies or refunds with respect to any years affected by the change and ending before 1964. Taxpayers are also to have an opportunity to make a new election with respect to the foreign taxes for this back period—to take either a deduction or a tax credit as the changed circumstances arising from the longer carryforward of losses (and no carryback of these expropriation losses) warrant.

The types of losses involved are trade or business, or production of income, losses which are "sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or agency or instrumentality of the foregoing * * *." Such a loss is to be considered a "foreign expropriation loss."

A foreign expropriation loss will be treated separately from any remaining net operating loss for the same year. The regular net operating loss for the year will be carried back and used up to the extent of the income in the 3 prior years. Then, if any of the regular net operating loss still remains, it will be carried forward to the next year and used first. Only after the net operating loss is fully applied in the first carryforward year will any expropriation loss from the same year be used in that year. Thus, the expropriation loss will be considered the last portion of the total net operating loss applied in any case, although the expropriation loss for a year will be applied before the regular net operating loss for any succeeding year.

(c)(*i*) *Effective date.*—This provision applies with respect to foreign expropriation losses arising in taxable years ending after December 31, 1958.

(*d*) *Revenue effect.*—This provision is expected to result in a revenue loss of approximately $5 million a year in 1965, but it expected to decline appreciably after 1970.

15. One percent limitation on medicines and drugs for those over age 65 (sec. 211 of the bill and sec. 213 of the code)

(*a*) *Present law.*—Under present law, generally only what are considered abnormal medical expenses are deductible. This result is attained by limiting expenses which may be deducted to the excess of these expenses over 3 percent of the individual's adjusted gross income (income after business and similar expenses but before personal exemptions and personal expenses). In computing medical expenses subject to this 3-percent limit, medicines and drugs may be taken into account only if they exceed 1 percent of adjusted gross income. The 3-percent limitation does not apply in the case of the taxpayer and his spouse where either of them is 65 or over nor does it apply in the case of medical expenses of the mother or father of the taxpayer or of his wife where the parent is 65 or over and receives his principal support from the taxpayer. The 1-percent limitation on medicines and drugs, however, applies to everyone without regard to their age.

(*b*) *General reasons for provision.*—The House bill repeals the 1-percent limitation with respect to medicines and drugs insofar as it relates to a taxpayer, or his spouse either of whom is age 65 or over, or to the parent of the taxpayer (or his spouse) where the parent is a dependent of the taxpayer and is 65 or over. The effect of this is to provide that the 1-percent limitation will apply only in those cases where the 3-percent limitation also applies. Your committee is in accord with this action, because it, like the House, believes that it is undesirable to impose any minimum limitation with respect to the deductibility of medical expenses in the case of the aged. It also believes that conforming the application of the 1-percent limitation with the 3-percent limit will simplify the statute somewhat in this area.

(*c*) *General explanation of provision.*—Present law provides that medicines and drugs which otherwise would be taken into account in computing medical expenses (which are either deductible in whole, or to the extent they exceed 3 percent) are to be deductible only to the extent that the total of these medicine and drug expenses exceed 1 percent of the taxpayer's adjusted gross income. Both the House and your committee's version of the bill make this 1-percent limitation inapplicable in the case of amounts paid for the care of the taxpayer and his spouse if either of them has attained age 65 before the end of the taxable year. Both versions also provide that this 1-percent limitation is not to apply to amounts paid for the care of a dependent mother or father of the taxpayer or his spouse if the mother or father has attained age 65 before the end of the year and also is a dependent of the taxpayer. Thus neither the 3-percent limit on medical expenses generally nor the 1-percent limit on medicines and drugs will apply to the categories of persons specified above who are age 65 or over. The maximum limitations on medical expenses, however, continue to apply to these and other persons in the same manner as under existing law.

(*c*)(*i*) *Effective date.*—This provision is to apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a revenue loss of $10 million in a full year of operation.

16. Care of dependents (sec. 212 of the bill and sec. 214 of the code)

(*a*) *Present law.*—Under present law, a deduction of up to $600 is allowed in certain cases for expenses of child care incurred to enable a taxpayer to be gainfully employed. At present, this is available for single women, women who are divorced or separated, or in some cases, deserted, and widows and widowers, having one or more dependents without regard to the amount of the taxpayer's earnings. In the case of working wives, the $600 deduction is presently available only if the combined adjusted gross income of the wife and husband (who must file a joint return) does not exceed $4,500. If their income exceeds this amount, the deduction available is decreased $1 for each dollar of income above $4,500, thus disappearing entirely at an income level of $5,100. An exception to this rule provides that this income limitation is not to apply if the husband is incapable of self-support because mentally or physically defective.

A dependent of the taxpayer for whom this $600 may be claimed must be a son or daughter (or stepson or stepdaughter) of the taxpayer who is under age 12 or a dependent who is physically or mentally incapable of caring for himself.

(*b*) *General reasons for provision.*—Your committee, while agreeing with the changes made by the House bill in the child-care provision, found them too narrow. As a result, it has liberalized the changes made by the House bill to also include the principal changes recommended by the administration with respect to this provision which were omitted in the House bill. These changes have also been recommended by the President's Commission on the Status of Women. The most important change made by your committee in the House provision is to raise from $4,500 to $7,000 the income limitation applicable with respect to working wives. In 1954, when provision was first made for the deduction of child-care expenses with respect to working wives, your committee in its report then stated:

> * * * [I]t is recognized that in many low-income families, the earnings of the mother are essential for the maintenance of minimum living standards even where the father is also employed, and that in such situations, the requirement for providing child care may be just as pressing as in the case of a widowed or divorced mother.

Thus, Congress provided for the deduction of child-care expenses in the case of working wives because it was recognized that the maintenance of a minimum standard of living in these cases required the wife to work. However, the present maximum joint income level of $4,500 is so low that relatively few working wives presently can claim this deduction. Of the 244,000 taxable returns claiming the deduction in 1960, only 117,000 were joint returns filed by married couples. In 1961, according to Department of Labor statistics, the median income of husband-wife families in which the wife worked at any time during the year was $7,050. Thus, the $4,500 limitation falls far short of covering the average case where the wife has found it necessary to supplement the husband's income by working. To carry out the original intention of Congress with respect to this provision, your committee's bill raises the joint income limitation for husbands and wives who may claim the child-care expense deduction from $4,500 to $7,000.

Under present law, the maximum amount which may be deducted for child care is $600 per year per taxpayer. As the House report indicates a flat limitation of this type fails to take into account the fact that the costs of caring for dependents, particularly where they must be cared for outside of the home, increases as the number of dependents increases. Because of this, the House bill raised the maximum deduction which may be claimed for child-care expenses to $900 where the taxpayer has two or more dependents. Your committee's bill carries this one step further and provides a maximum deduction of $1,000 where there are three or more qualifying dependents. It also makes this graduated maximum available in the case of working wives as well as where there is only one parent. These expenses are as likely to increase on a per-child basis in the case of a married couple as in those cases where there is only one parent.

In other respects, your committee's amendments, with minor technical exceptions, follow the House bill. Thus, as under the House bill, relief is provided where the wife is either in an institution or is physically or mentally incapable of caring for herself. Under present law, if the husband is incapable of self-support because of mental or physical deficiencies, the wife is fully eligible for the deduction without regard to the family income level. Your committee agrees with the House that a family where the wife is in an institution is at least as likely to incur expenses for child care as a family where the husband is incapable of self-support. Similarly, it also agrees that child-care expenses are likely to be required, where the wife is in the home but not capable of caring for herself. As under the House bill, your committee's amendments extend present law to permit child-care expenses in these cases, subject to limitations, to be deducted. Your committee in this regard modified the House provision only in that in the case of incapacitated wives, the deduction is to be fully available where the adjusted gross income of the taxpayer and his spouse does not exceed $7,000 rather than $4,500. This is in conformity with its change in the income level generally applicable in the case of working wives.

Both the House and your committee's bill also raise the maximum age limit generally available from 12 to 13 years for children with respect to whom the child-care deduction generally may be taken.

(c) *General explanation: Raising income limitation from $4,500 to $7,000.*—Your committee's amendments, as distinct from the House bill, increase from $4,500 to $7,000 the amount of income that families with working wives can earn and still qualify for the full amount of the deduction for expenses incurred for the care of children or dependents. The House bill made no change in this area. This raising of the income limitation to $7,000 is in accordance with the recommendation of the administration.

Under present law, for every dollar of income a husband and working wife have above $4,500, the maximum limit on their deduction for child-care expenses is reduced by a similar dollar below the $600 level. Thus, under present law with the $600 limitation, it is possible for a husband and working wife to receive some child-care expense deduction in the case of those with incomes up to $5,100. Under your committee's bill, since the maximum child-care expense deduction (where there are three or more children) is raised to $1,000, it will be possible for husbands and wives who are both working to claim some

child-care expense deductions in cases where their joint incomes are up to $8,000. In 1960, the child-care expense deduction was claimed on 244,000 taxable returns. It is anticipated that the liberalizing amendments, primarily raising the income level for working wives to $7,000, will make this deduction available to an additional 200,000 returns or 444,000 taxable returns in all.

(c)(i) *General explanation: Raising the deduction to $900 or $1,000 in certain cases.*—Under present law, as previously indicated, the maximum annual deduction which may be claimed by a taxpayer is $600. The House bill, where there are two or more qualified dependents, would raise this maximun deduction which may be taken, for expenses incurred by the taxpayer, to $900. Your committee's amendments provide that the $600 limitation, as under the House bill, is still to be applicable where the taxpayer has only one dependent and that the $900 limitation is to be applicable where the taxpayer has two dependents. However, it provides that where there are three or more qualifying dependents, the maximum deduction which may be taken is to be $1,000, in lieu of the $900 provided by the House bill. The $900 and $1,000 limitations are also to be available in the case of working wives who are eligible for the child-care deduction (under the House bill, the $600 limitation would continue to apply in such cases).

(c)(ii) *General explanation: Incapacitated and institutionalized wives.*—The House bill adds to the list of situations where the child-care deduction may be claimed those cases where a wife is incapacitated or institutionalized. Your committee's amendments accord substantially the same treatment. For the husband to be eligible for this deduction, the wife must be institutionalized or incapacitated for 90 consecutive days (or a shorter period if she dies). In the case of incapacitated wives, under the House bill the deduction would be fully available only where the adjusted gross income of the taxpayer and his spouse does not exceed $4,500 (for incomes above that level, the deduction would decrease $1 for each dollar of income above $4,500). Under your committee's amendments, the $4,500 limitation in this case is replaced by the $7,000 limitation. The income limitation under both the House bill and your committee's amendments does not apply if the taxpayer's wife is institutionalized for a period of 90 days or more. A wife is considered as being incapacitated if she is incapable of caring for herself because she is mentally or physically defective (including any time she is institutionalized). A wife is considered institutionalized while she is receiving medical care or treatment as an inpatient, resident, or inmate of a public or private hospital, sanitarium, or similar institution.

(c)(iv) *General explanation: Raising the age limit for children to 13.*—Present law provides that a dependent, for purposes of the child-care deduction (if not physically or mentally incapable of caring for himself), must be a son or daughter (or stepson or stepdaughter) of the taxpayer and must not have attained the age of 12. The House bill raises this age limit to 13 and your committee's amendments make no change in the House bill in this respect.

(c)(v) *Effective date.*—The amendment made by this provision apply to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—Changes made by the House bill with respect to the child-care provision in a full year of operation would have resulted in a revenue loss of $5 million. The changes made by your

committee increase this loss by $15 million or to a total of $20 million when compared with present law.

17. Moving expenses (sec. 213 of the bill and sec. 217 of the code)

(*a*) *Present law.*—Under present law, certain moving expenses of existing employees if reimbursed by the employer are held to be excludable from the employee's income. They have been ruled excludable on the ground that they are incurred "in the interest of the employer" (Rev. Rul. 54–429, C.B. 1954–2, 53).

Under present law, the moving expenses (for moving from one official station to another for permanent duty) which the Internal Revenue Service has agreed are excludable for existing employees where they are reimbursed are:

1. Transportation expenses for moving the employee and his family;
2. Transportation and certain related costs of moving the personal and household effects of the employee and his family; and
3. Expenses incurred for meals and lodging for the employee and his family while they are en route to their new location.

In addition, in two court cases, taxpayers have been permitted to exclude other types of moving expenses, although the Internal Revenue Service has not acquiesced in the exclusion of these other types of moving expenses.[1]

On the other hand, reimbursements for moving expenses received by new employees from their employers are includible in gross income. Moreover, no deduction is allowed for moving expenses of any employee with respect to expenses for which no reimbursement is received.

(*b*) *General reasons for provisions.*—Your committee agrees with the House that the existing tax treatment of moving expenses needs modification because the present treatment discriminates against both new employees and employees who are not reimbursed for their moving expenses by their employers. There is no reason why new employees should include in their income amounts representing moving expenses which, if received by an existing employee who is moved by his employer from one location to another, would be excludable from income. Neither is there any reason for discriminating against those employees who are not reimbursed for their moving expenses, but who incur such expenses in seeking job opportunities. Moreover, it is important to remove deterrents to the mobility of labor. Any thing which can be done in this respect should aid in reducing local structural unemployment.

Both the House and your committee's bill limit the categories of expense for which a deduction is available to new employees or those who are not reimbursed for moving expenses to the three categories specified above, which, by ruling, the Internal Revenue Service recognizes the reimbursements of which are as excludable for existing employees. No inference should be drawn from this, however, that moving expense exclusions under existing law are necessarily limited

[1] In *John E. Cavanagh* (36 T.C. 300; 1961) it was held that living costs incurred by the employee in excess of ordinary living expenses of his family were excludable where they were reimbursed while his household effects were in transit. In *Otto Sorg Schairer* (9 T.C. 549; 1947) it was held that where an employee was reimbursed for a loss incurred in selling his home this reimbursement was an addition to the sales price. More recently, however, the Tax Court held that reimbursements of similar expenses were additional compensation and not excludable from the employee's income in the case of *Harris W. Bradley* (39 T. C. 652; 1963 aff'd, 324 F. 2d 610 (4th Cir. 1963). A reimbursement on sale of a house was also held to be compensation in *Arthur V. Kobacker* (37 T.C. 882; 1962).

to these three categories of expenses. However, since by administrative ruling, these categories are clearly excludable in the case of existing employees who are reimbursed, it is believed that deductions for such expenses should also be made available to new employees and nonreimbursed employees as well. The question of whether the exclusion for existing employees extends beyond these three categories is left for judicial interpretation.

(c) *General explanation of provisions.*—The deductions allowed by the House and your committee's bill with respect to moving expenses are to be deductible in computing "adjusted gross income." These expenses, therefore, are deductible whether the individual involved itemizes his personal deductions or takes the standard deduction. This treatment is provided not only because these expenses are substantially similar to business expenses, but also because when they are incurred, they are likely to be relatively large. In such cases, it was thought that it would be undesirable to, in effect, make taxpayers choose between taking this deduction and the standard deduction in lieu of itemized personal deductions.

No deduction is provided under this provision for moving expenses for which the taxpayer receives reimbursements which are not included in his gross income. Thus, existing employees may continue to exclude reimbursed moving expenses from their gross income in the same manner as under present law. Their status, in this regard, is left entirely unchanged.

The types of moving expenses which may be deducted under this provision are reasonable expenses for—

1. Moving household goods and personal effects from the former residence to the new residence;
2. Transportation expenses of the employee and his family from the former residence to the new place of residence; and
3. Expenses for meals and lodging while in transit from the former residence to the new place of residence.

The moving expenses referred to are available not only with respect to the taxpayer, but also to any other members of the taxpayer's household who had as their permanent place of abode the taxpayer's former residence and moved to his new residence. (For amendment added by your committee with respect to sales of residences of employees who are moved see sec. 232 of the bill, item 39 below.)

(c)(i) *Limitations.*—To prevent the deduction of moving expenses for short moves, the bill provides that, for a deduction to be available, the taxpayer's new place of work must be at least 20 miles farther from his former residence than was his former place of work. In other words, his commuting distance must have increased by at least 20 miles to be eligible for this deduction. If the individual involved previously had no place of work, his new work location must be at least 20 miles from his former residence.

To prevent individuals from taking temporary jobs in order to obtain the deduction of moving expenses, it is provided that during the 12-month period immediately after the individual's arrival at his new principal place of work, he must be a full-time employee in that general location for three-fourths of the time (39 weeks). This limitation, however, is not applied to the extent where the individual is reimbursed for his moving expenses by his employer since, presumably, an employer would not reimburse such expenses even for a new

employee unless it was his intention that the individual remain employed for an extended period of time.

This requirement that an employee be a full-time employee in a general location for three-quarters of a year after moving means that where he has moved after the first half of the year, he cannot be sure when he files his return in the following April that he will meet this 9 months' requirement. For that reason, the employee in such a case is permitted to claim the moving expense deduction (assuming he has not already disqualified himself by that time, such as by moving out of the general location). Then, if after filing his return he fails to qualify for the moving expense deduction by not remaining employed full time for 39 weeks in the new location he is to include in his gross income for the following year the amount of moving expense deduction claimed in the prior year.

(c)(ii) *Effective date.*—The new treatment provided by this provision applies to expenses incurred after December 31, 1963.

(d) *Revenue effect.*—It is anticipated that this provision in a full year of operation will result in an annual revenue loss of $60 million a year.

18. Deduction for political contributions (sec. 214 of the bill and sec. 218 of the code)

(a) *Present law.*—Up to the present no deduction or credit has been allowed for political contributions of any type. In fact, charitable and educational contributions presently may be denied if the organizations involved spends any substantial part of its activities in attempting to influence legislation.

(b) *General reasons for provisions.*—Your committee's bill departs with the precedent in this respect primarily because of the report of the late President Kennedy's Commission on Campaign Costs and because of his recommendation to Congress with respect to this report. This section, while not identical to the proposal of the late President, nevertheless is substantially similar to it, and in your committee's opinion carries out the objectives of that request. The purpose of allowing a limited deduction for campaign contributions is, as indicated by the late President, to broaden the base of contributions: "to reduce dependence on large contributions of those with special interests." As he indicated, this section "is designed to give party solicitors an additional tool to help stimulate individuals to contribute money, in * * * election years."

(c) *General explanation of provision.*—The new section added by the bill allows a deduction for political contributions up to a maximum of $50 a year in the case of a single person (or a married person filing a separate return) and up to $100 a year in the case of a married couple filing a joint return. The amounts for which deductions are permitted are limited in order to achieve the objective of the late President Kennedy in "broadening the base of political contributions."

These deductions are available only to those who itemize their deductions, rather than taking a standard deduction. Therefore, this places these limited deductions for political contributions in the same category as charitable contributions, deductible taxes, interest, certain medical expenses, etc.

The bill provides that this deduction for political contributions is to be allowed only if the fact of the political contribution is verified in such manner as the Secretary of the Treasury or his delegate prescribe

by regulation. It is anticipated that under this grant of authority the Secretary of the Treasury will provide that the deduction will be available only where the taxpayer, if his return is audited, presents adequate records to show that he has actually made the political contributions to a qualified candidate or committee. This will give assurance against the claiming of deductions for fictitious political contributions.

A political contribution which as a result of the new section added by the bill will be deductible must be a contribution or gift to a "political candidate" or "political committee." However, in addition, it is required that the contribution be made only for the purpose of furthering the candidacy of one or more individuals in a general, special, or primary election or a convention of a political party. Thus, contributions or gifts to further the cause of a referendum or other issue on a ballot will not be deductible. The candidate with respect to which the deduction of a contribution or gift may be claimed may be a candidate for National, State, or local office and may be either a partisan or nonpartisan candidate. Thus, for example, where judges are elected officials, contributions for their candidacy may be deducted. The candidacy of the individual may be either for a primary election or for a convention of a political party nominating candidates for office or for a general election. Included also are special elections to fill vacancies.

The deduction for political contributions under the bill is limited to contributions made by individuals. It is not available with respect to contributions from corporations or from estates or trusts.

(*c*)(*i*) *Effective date.*—The bill provides that contributions or gifts made after the date of enactment of this bill are to be deductible.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a revenue loss of approximately $25 million a year for Presidential election years; 50 percent of that amount for congressional election years; 25 percent for off years; and average about $15 million per year.

19. One hundred-percent dividends received deduction for members of electing affiliated groups (sec. 215 of the bill and sec. 243 of the code)

(*a*) *Present law.*—Present law in general provides a deduction equal to 85 percent of the dividends received by one corporation from another domestic corporation. This has the effect of taxing 15 percent of intercorporate dividends received. With the present 52-percent tax rate, this is a tax of 7.8 percent on the entire dividend (15 percent times 52 percent), or in the case of the 48-percent rate effective under this bill for corporations in 1965 and subsequent years, a tax on the entire dividend of 7.2 percent.

(*b*) *General reasons for provision.*—The administration in its initial recommendation to Congress proposed that the 2-percent penalty tax on consolidated returns be repealed that controlled groups be limited to a single surtax exemption, and also, that the intercorporate dividends received deduction be increased to 100 percent in the case of amounts received as a dividend from a corporation which is a member of the same parent-subsidiary affiliated group. In this regard, the Secretary of the Treasury in his explanation of this provision to the Ways and Means Committee stated:

> The elimination of the intercorporate dividend tax in this type of parent-subsidiary relationship would extend to such

> groups one of the tax advantages generally now available only to affiliated groups which file consolidated returns. This amendment is designed to facilitate the adjustment to the elimination of multiple surtax exemptions in cases where the affiliated group does not, or cannot, file consolidated returns, but would recognize that the earnings of an 80-percent-owned operating subsidiary are more directly the earnings of the parent than is the case where one corporation merely derives investment income from an unrelated corporation.

Your committee is in accord with this recommendation of the administration. Your committee concluded that it would be inequitable to repeal the consolidated return 2-percent tax without also providing a 100-percent intercorporate dividends received deduction for corporations meeting the same tests of common ownership, but which for one reason or another cannot, or do not want to, file a consolidated return and are willing to forgo multiple surtax exemptions. Among the principal reasons for not being eligible to file a consolidated return in the case of an affiliated group is the need for different members of a group to maintain different fiscal years due to variations in the natural business years of the different companies involved. Still another factor accounting for some corporations in an affiliated group not filing consolidated returns is the necessity to use the same accounting method (unless the Internal Revenue Service specifically permits a variance) although there may be valid business reasons for the different accounting methods in the case of the different businesses. Another reason which applies in the case of life insurance companies is that under present law such companies may not file a consolidated return with other domestic corporations which are not life insurance companies. Moreover, still other corporations are hesitant to file consolidated returns because of the sheer complexity of the consolidated return regulations.

For these reasons, your committee has added a provision granting a 100-percent dividends-received deduction in those cases where corporations are affiliated but they do not file a consolidated return. To be sure that no special advantage was given these corporations over those corporations which do file consolidated returns, your committee has reviewed the various provisions of the code and denied tax benefits in those cases where the separate corporations received significant advantages over a consolidated group. Thus, where this 100-percent dividends-received deduction is elected, the group is to have only one $25,000 surtax exemption for the group, the election with respect to foreign tax credits or deductions must be the same for all members of the group, only one $100,000 minimum accumulated earnings credit is to be allowed in determining exemptions from the tax on unreasonable accumulations, only one $100,000 exemption in computing estimated tax subject to accelerated payments is to be allowed, and limitations generally applicable to a single corporation are provided in the case of exploration expenditures.

(c) *General explanation of provision.*—A 100-percent dividends-received deduction is allowed by your committee's amendment when dividends are paid by a domestic corporation but only where the dividends are "qualifying dividends." To be qualifying dividends

they must be received from a corporation which is a member of the same affiliated group of corporations. "Affiliated group" for this purpose is defined in the same manner as an affiliated group for purposes of the requirement for filing a consolidated return except that a domestic insurance company (taxable under section 802 or 821) is treated as an includible corporation. For the dividends to be qualifying, the receiving and distributing corporation must be members of the same affiliated group at the time of the distribution and also the dividends must be distributed out of earnings and profits of a year ending after December 31, 1963, when on each day of which the two corporations were members of the same affiliated group and were not claiming multiple surtax exemptions.

The determination as to what earnings and profits a dividend is considered as being distributed out of will be made under the rules applicable elsewhere in the code for this purpose; i.e., they will be considered as paid first out of the current year's earnings and profits and then, to the extent of any excess, out of the prior year's earnings and profits, then, to the extent of any excess, out of the second prior year's earnings and profits, etc. In addition, the dividends must be paid at a time when the distributing and receiving corporations are members of an affiliated group which has elected to qualify for the 100-percent dividend-received treatment provided by the new section.

An election must be made by the parent corporation and consented to by each of the subsidiary corporations. The election is effective for the taxable year of the subsidiaries which includes the last day of the year of the parent with respect to which the election was initially made. In addition, the election applies automatically for each succeeding year unless the election is specifically terminated. A special rule provides that with respect to fiscal years beginning in 1963 and ending in 1964, the election would be effective as long as the last day of the corporation's year is included in a year of the parent for which an election is effective.

An election may be terminated by an affiliated group if the affiliated group files a termination of the election and each member of the group consents to this termination. In addition, the election may be terminated where a new member is added to the affiliated group and this member files a statement to the effect that it does not consent to the election.

Where an affiliated group elects the 100-percent dividend paid treatment, the members of the group must forego certain advantages which they otherwise would have as separate corporations. These rights are withdrawn since they are not available to a group filing a consolidated return, where the tax advantages are substantially similar to those provided in the case of the 100-percent dividends received deduction. The advantages of separate treatment which the affiliated group must forego if this election is made are as follows:

1. The group may not elect to receive more than one surtax exemption.

2. All members of the group must all make the same elections with respect to foreign taxes; i.e., they must all elect either to claim deductions for these foreign taxes or foreign tax credit; and, if they claim foreign tax credit, they must all either elect the "per country limitation" or the "overall limitation" in computing the size of the credits available. They will each, however, continue to compute their own

foreign tax deduction or credit in the same manner as separate corporations.

3. In determining whether or not the various corporations in the affiliated group are subject to the accumulated earnings tax (imposed by section 531), only one $100,000 minimum accumulated earnings credit would be available for the entire group.

4. In determining the tax liability of the group which will be subject to estimated tax (i.e., acceleration of corporate payments so that the tax is paid in the year of liability rather than in the succeeding year), only one exemption of $100,000 of tax liability is to be available to the entire group rather than to each member of the group.

5. In determining the maximum amount of exploration expenditures with respect to mineral deposits which may be written off in any one year or treated as a deferred expense the group of affiliated corporations making this election is to be eligible to write off one $100,000 in any one year with a total of $400,000 over any number of years.

Except for the $100,000 minimum accumulated earnings credit, it is anticipated that the members of the affiliated group will be permitted to apportion the $100,000 exemptions, limitations, or the $400,000 limitation in any manner that they see fit.

Life insurance companies and mutual casualty insurance companies may not file a consolidated return with any other companies except other life insurance companies of the same type. Under your committee's amendment, however, dividends from, or to, such insurance companies are eligible for the 100-percent dividends received deduction if the entire affiliated group of which the insurance company is a member consents to the tax treatment provided by this section.

(*c*)(*i*) *Effective date.*—This 100-percent dividend deduction treatment is to apply with respect to dividends received in taxable years ending after December 31, 1963.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a revenue loss of approximately $5 million a year.

20. Interest on loans on certain insurance and annuity contracts (*sec. 216 of the bill and sec. 264 of the code*)

(*a*) *Present law.*—Under existing law, no interest deduction is allowed in the case of indebtedness incurred or continued to purchase, or carry, a single-premium life insurance, endowment, or annuity contract. In addition, if substantially all the premiums on a contract are paid within 4 years of the date on which the contract was purchased, the contract is treated as if it were a single-premium contract for purposes of this provision. Similarly, where a purchaser borrows an amount equal to a substantial portion of the premium payments on a contract, but, instead of purchasing the policy outright, deposits the borrowed funds with the insurance company for future payments on a policy, this also is treated as if it were a single-premium contract and the interest deduction on the indebtedness relating to the contract is denied. However, under present law, no interest deductions are denied where the taxpayer purchases an insurance contract with the intention of borrowing the maximum amount on the contract each year, unless the contract falls in one of the categories described above.

(*b*) *General reasons for provision.*—It is understood that life, or other insurance policies are being sold to individuals on the basis that they cost the individual little or nothing, and in some cases on the

grounds that they actually result in a net profit for him. In such cases, the taxpayer each year borrows all, or a substantial part, of the funds necessary to pay the premium on the policy. If he is in a 50-percent (or higher) tax bracket, since the interest payments on such loans are presently deductible, the net interest cost to him is one-half or less of the interest payments he makes. The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured. Because of this, some insurance companies have sold insurance policies under plans which provide for the taxpayer borrowing the premiums either directly from the insurer, or from a bank or otherwise, primarily on the grounds that the policies are tax-saving devices. Both the House and your committee doubt that the sale of insurance on such a basis is either desirable or fair to taxpayers generally.

However, the importance of being able to borrow on insurance policies is recognized; and, therefore, while adopting a provision designed at minimizing the sale of insurance as a tax-saving device, the House and your committee have been careful in this provision to provide for the retention of rights to borrow on insurance for other than tax-saving purposes without the loss of the interest deduction.

One of the Treasury's proposals on which neither the House nor your committee took any action involves the tax treatment of split-dollar life insurance arrangements, which are closely related to this bank loan insurance provision. These are arrangements entered into jointly by an employer and employee under which part of the premiums on a life insurance policy are paid by each. It is believed that the issues involved in this problem, and the proper solution, including the possibility of administrative action, are in need of further study by the Treasury Department.

(*c*) *General explanation of provision.*—Both the House and your committee's bill provide that interest paid on indebtedness incurred or continued to pay premiums on life insurance contracts, endowment contracts, or an annuity is not to be deductible if the individual is following a plan of systematically borrowing amounts equal to the increase in the cash value of the insurance contract to pay part or all of the premiums. The interest deduction is to be denied whether the borrowing is direct or indirect; that is, whether it is from the insurance carrier, from a bank, or from any other person. It also is intended to cover cases where the individual borrows on other property or on his general line of credit to pay the premiums. This provision is not to apply to a single-premium contract or to a contract treated like a single-premium contract, since present law already denies a deduction in these cases.

In effect, where the taxpayer systematically borrows the increase in the cash value of his policy he is converting what generally is a permanent form of life insurance into substantially the equivalent of renewable term insurance. In this case, however, he retains the right to restore the contract to permanent insurance as of the original

age at which he took out the contract by repaying the amount borrowed from the insurance company, bank, or other person.

The House bill would apply only to insurance or annuity contracts purchased after August 6, 1963, the date the House Committee on Ways and Means first announced its action on this matter. Your committee has amended the provision so that it will apply only to contracts purchased after December 31, 1963, to bring this provision into line with the general effective dates provided in this bill for structural changes. In any event, both the House provision and the provision as amended by your committee will only affect contracts entered into after the specified date and will have no effect on contracts entered into before that date even in the case of borrowings on such a contract in the future.

(c)(i) *Exceptions.*—Both the House and your committee desire to be sure that the value of insurance generally would not be decreased by reducing the rights of the individual to borrow on the insurance, as he can in the case of other forms of assets. For this reason, a number of exceptions to the general rule are added where, even though the borrowing may take the form of a systematic plan, nevertheless this provision is not to apply. These exceptions are as follows:

1. The interest deduction is to be allowed if there is no borrowing with respect to any four of the annual premiums payable on the insurance or annuity contract in the first 7 years of the contract. However, to prevent avoidance of this provision by taking out a contract with very low premiums for the first 4 years, with the premiums being substantially greater thereafter, the bill contains a rule relating to situations of this type. It is provided that the 7-year period referred to above is to commence again at any time there is a substantial increase in the premiums payable under the insurance or annuity contract.

2. A de minimis rule is to apply. Thus, if the otherwise nondeductible interest of an individual with respect to an entire taxable year does not exceed $100, no interest deduction will be denied.

3. In any event, no interest deduction will be denied if the debt was incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in financial obligations. Thus, for example, the interest deduction would not be denied where the individual systematically borrowed on a policy previously purchased because he, or his family, incurred large unforeseen medical bills or because he unexpectedly lost a substantial income source.

4. The interest deduction is not to be denied where the indebtedness actually is to finance business obligations, rather than to carry insurance. For example, an individual with an insurance policy would not have his interest deductions denied where it can be shown that the amounts borrowed by him were actually used to finance the expansion of inventory or for other similar business needs.

(c)(ii) *Effective date.*—This provision as amended by your committee applies to amounts paid in taxable years beginning after December 31, 1963, but with respect to policies purchased after December 31, 1963.

(d) *Revenue effect.*—It is estimated that this provision will result in an annual revenue gain of $5 million in 1964 and 1965 and $10 million when the provision is fully effective.

21. Interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds (sec. 217 of the bill and sec. 265(2) of the code)

(*a*) *Present law.*—Under present law, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from Federal income taxes. It has been held that interest paid on indebtedness represented by deposits in banks engaged in the general banking business is not subject to this provision since this indebtedness is not considered to be "incurred or continued to purchase or carry" tax-exempt obligations. This position which has been a long-standing administrative practice was specified by ruling in 1961 (Rev. Rul. 61–222, 1961–2 CB 58).

(*b*) *General reasons for provision.*—A witness before your committee called attention to the fact that financial institutions which are subject to the banking laws of a State, although not actually banks themselves, pay interest on face amount certificates—a way by which thousands of individuals throughout the country systematically invest their savings. In the example cited to your committee, a certificate holder pays to the financial institution equal monthly payments for 20 years and at the end of that time, the financial institution pays back the amount of the investment plus interest in accordance with the provisions of the certificate. The funds of the financial institution in this case are subject to regulation by the Investment Company Act which permits investment of the funds received from the certificate holder in "qualified investments."

Qualified investments for this purpose include real estate mortgages, certain property improvement loans, U.S. Government and municipal bonds, and other securities meeting certain performance standards. As a result, part of the financial institution's funds are invested in State and municipal bonds, the interest on which is exempt from Federal income tax.

Your committee concluded that in cases of this type the relationship of the financial institution to the certificate holder is sufficiently close to the relationship of a bank to its depositors as to permit the investment of a substantial portion of the funds of such an institution in tax-exempt State and municipal bonds without this resulting in the possible denial of the interest deduction with respect to amounts paid out to the certificate holders. Your committee therefore has amended the House bill to provide that interest deductions are not to be denied in the case of these types of financial institutions to the extent they invest not more than 25 percent of their assets in tax-exempt obligations.

Your committee intends that no inference be drawn from the fact that it has provided this treatment for the future as to the proper interpretation of the applicable law with respect to interest deductions for any prior year.

(*c*) *General explanation of provision.*—Your committee's amendment adds a sentence to the provision of existing law which denies a deduction for interest on indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from Federal income tax. The sentence added provides that financial institutions which are subject to the banking laws of the State in which they are incorporated are not to be denied interest deductions on face amount certificates (as defined in the Investment Company Act of 1940), or on amounts received for the purchase of these certificates, on the grounds that this interest is on indebtedness incurred or continued to

purchase or carry tax-exempt obligations. However, interest on these face-amount certificates is to be so treated only to the extent that the average amount of tax investments of the institution in the tax-exempt obligations do not comprise more than 25 percent of the average of the total assets of the institution. "Total assets" for this purpose means gross assets (taken at cost) less all of the liabilities other than the liability on the face-amount certificates.

(*c*)(*i*) *Effective date.*—This provision applies with respect to taxable years ending after the date of enactment of this bill.

(*d*) *Revenue effect.*—It is expected that this provision will result in a negligible revenue loss.

22. Repeal of requirement of allocation of certain traveling expenses (sec. 218 of the bill and sec. 274(c) of the code)

(*a*) *Present law.*—In the Revenue Act of 1962, Congress provided that where a person takes a business trip and this is combined with recreational or other personal activities, the cost of this trip in certain cases must be allocated between the business and personal activity, the former, but not the latter, being deductible for income tax purposes.

Exceptions in the statute provide that this allocation is not to be required where the trip does not take more than a week or where the time spent on the personal activities represents less than a quarter of the time away from home on the trip. In these cases, the entire expenses of travel, and meals and lodging while in travel status, are deductible as under prior law, where the taxpayer can establish that the trip is related primarily to business. Under the authority provided for prescribing, under regulation by the Secretary or his delegate, the amount of activity allocable to the trade or business, the Treasury Department has held that if the travel expense qualifies as an ordinary and necessary business expense, none of it will be disallowed (1) if the taxpayer does not have substantial control over arranging the business trip or (2) if he does not have the obtaining of a personal vacation as a major consideration in determining whether to make the trip.[1] The Internal Revenue Service has held that an employee who is reimbursed by his employer for his travel expenses is considered not to have substantial control over arranging the business trip providing he is not a managing executive of, or closely related to, his employer. Even a managing executive, or an individual who is closely related to his employer, is not affected if he can establish that he did not have substantial control over arranging the particular trip.[2] It is also indicated that mere control over the timing of a business trip will not itself represent substantial control.[3] Even where the person has substantial control over arranging the business-vacation trip, the Service has indicated that it will not be held to be partially allocable to nonbusiness activity unless obtaining a personal vacation or holiday was a major consideration in making the trip.[4] The Service has also indicated that if a major consideration in making the business trip is to visit a hospitalized relative, this will not result in any allocation of the travel expense for personal reasons. On the other hand, of course, if the primary purpose of the trip is to visit an ill relative

[1] U.S. Treasury Department, Internal Revenue Service, "Questions and Answers for the Businessman; Travel, Entertainment and Gift Expenses," Document No. 5495 (7–30–63), question No. 69.
[2] Op. cit., question No. 71.
[3] Op. cit., question No. 73.
[4] Op. cit., question No. 75.

for personal reasons, no deduction would be allowable for travel expense as under prior law.[5]

(*b*) *General reasons for the provision.*—There is at the present time a great deal of confusion as to the area of application of this provision and the rules developed by the Internal Revenue Service with respect to this provision are little understood by the general public. It is recognized that the Internal Revenue Service in its interpretation of this provision has attempted to remove the harsher aspects in its application. However, this also has had the unfortunate effect of complicating the provision to such a degree that it is not generally understood by the traveling public. Moreover, the area of application of the provision is so restricted, since it applies only to self-employed persons and to employees who are managing executives or related to employer, and in many cases not to them, that your committee concluded that the provision in its present form served little purpose. In view of these considerations your committee has added a section to the bill repealing this travel allocation rule retroactively to the date of its enactment in the Revenue Act of 1962.

(*c*) *General explanation of provision.*—The section added by your committee repeals the subsection adopted in 1962 which required a person taking a business trip, which was also combined with recreational or other personal activities, to allocate the cost of the trip between the business and personal activities, deducting the former and not the latter. This allocation was not required where the trip does not take more than a week or where the time spent on personal activity represents less than a quarter of the time away from home on the trip.

(*c*)(*i*) *Effective date.*—This provision is repealed as of the date of its enactment; namely, for periods after December 31, 1962.

(*d*) *Revenue effect.*—It is estimated that the repeal of this provision will result in a revenue loss of $5 million a year.

23. Acquisition of stock in exchange for stock of corporation which is in control of acquiring corporation (sec. 219 of the bill and sec. 368 of the code)

(*a*) *Present law.*—Under present law, a subsidiary corporation can acquire the assets of another corporation in exchange for its parent company's stock. This is a tax-free reorganization (under sec. 368(a)(1)(C)). In addition, following this tax-free reorganization the acquired assets can be transferred to a subsidiary corporation without affecting the tax-free nature of the reorganization.

Under present law, it is not possible, however, for a subsidiary corporation to acquire tax free the stock of another corporation in exchange for the stock of its parent corporation. In such a case, for the reorganization to be tax free, present law requires that the subsidiary corporation transfer its own stock in exchange for the stock of the other corporation, rather than the stock of its parent.

(*b*) *General reasons for provision.*—The Supreme Court in *Groman* v. *Helvering* (302 U.S. 82) and *Helvering* v. *Bashford* (302 U.S. 454), found that exchanges in which the parent corporation transferred stock while its subsidiary corporation received stock or the assets of another corporation did not qualify as tax-free reorganizations because the required "continuity of interest" was lacking.

[5] Op. cit., question No. 76.

In the 1954 code, in order to avoid the results of the *Groman* and *Bashford* decisions, the law was amended to provide that the subsidiary corporation could acquire the assets of another corporation in exchange for its parent corporation's stock (in tax-free reorganization under sec. 368(a)(1)(C)). The 1954 code also provided that following this reorganization, the acquired assets could be transferred to a subsidiary corporation without destroying the tax-free status of the reorganization.

Thus, the 1954 code permits tax-free reorganizations in the case of the exchange of the parent's stock for the assets of a corporation acquired by the subsidiary. However, a similar result is denied where the subsidiary acquires the stock of the other corporation in exchange for the stock of its parent corporation. Since Congress has considered the "continuity of interest" rule satisfied in the case of asset acquisitions, there seems to be no reason for not applying the same rule to stock acquisitions, since there is little in substance to distinguish an asset acquisition from a stock acquisition.

As a result, your committee has concluded that it is desirable to treat these two types of acquisitions in the same manner. For that reason, it has provided tax-free status for the stock-for-stock reorganization in the same manner that present law provides a tax-free status for stock-for-assets reorganizations.

(*c*) *General explanation of provision.*—This provision amends the definition of a stock-for-stock reorganization (known as a (B) reorganization) to qualify as a tax-free reorganization a transaction in which a subsidiary corporation acquires the stock of another corporation (and after that is in control of the corporation) in exchange solely for the voting stock of its parent corporation. Present law is also amended to permit the subsidiary corporation acquiring the stock of another corporation in the "(B) reorganization" to transfer all or part of this stock to another corporation which it controls. In addition, conforming changes have been made to the definition of the term "party to the reorganization".

(*c*)(*i*) *Effective date.*—The amendment made by this provision applies with respect to transactions after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible loss in revenue.

24. Retroactive qualification of certain union negotiated multiemployer pension plans (sec. 220 of the bill and sec. 401(i) of the code)

(*a*) *Present law.*—Under present law, a pension trust is qualified for income tax exemption only if it meets certain requirements relating to coverage of employees and nondiscrimination of contributions or benefits. Where the pension trust is properly qualified, not only is it exempt from Federal taxation with respect to its income, but contributions paid to it by an employer on behalf of his employees are deductible for Federal income tax purposes. Thus, it is of great importance for a pension trust to meet the requirements of the Internal Revenue Code and thereby become a qualified trust.

(*b*) *General reasons for provision.*—On several occasions in recent years bills have been presented to Congress and enacted into law providing for the retroactive qualification of specific pension trusts which could not initially qualify for exemption but after a period of time were able to do so. An example of this is the pension plan of local union No. 435, International Hod Carriers Building and Com-

mon Laborers' Union of America which was retroactively made a qualified trust by Congress in section 25 of the Revenue Act of 1962.

These plans are multiemployer pension plans established under colective bargaining agreements between a union and several employers. The regulations under present law (Regulations sec. 1.401-1(a)(2)) require that a "definite written program and arrangement" be communicated to the employees. This requirement cannot be met without delay in many cases of these multiemployer pension funds. However, the employers are required by the collective bargaining agreement entered into to begin making contributions under a general formula when the agreement is signed. However, to determine a schedule of benefits under one of these plans, frequently a complex actuarial study must be made, including a census of the employees of all of the participating employers. This requires a substantial period of time and during this period there can be no "definite written program." Therefore, there cannot be a qualified plan during this period and the contributions required under the union agreement, where they are not vested, cannot be deducted by the employers.

Because of the severe consequences of the failure to qualify for deductions during this period, Congress has from time to time provided retroactive qualification of plans where they subsequently become qualified and where the pension trust in the meanwhile was not operated in a manner which jeopardized the interests of its beneficiaries. To make it unnecessary to consider each one of these plans separately for retroactive qualification, the Treasury Department has recommended to Congress that it be given general authority to qualify these plans retroactively to the date of their creation where certain tests are met: The plans subsequently must become qualified and in the interval the trust must have been operated in a manner which substantially meets the tests under which the plan subsequently qualifies and the interests of the beneficiaries during this period must not in any way have been jeopardized. Your committee is in accord with the Treasury Department's recommendation and, therefore, has added a new section to this bill to provide retroactive qualification for these plans in such cases.

(c) *General explanation of provision.*—Your committee's amendments provide that a trust which is a part of a pension plan which the Secretary has found to be a "qualified trust" and one which is itself exempt from taxation is to be considered as a trust which was a "qualified trust" and as one which was exempt from taxation from the period beginning with the date when contributions were first made to the trust rather than beginning with the date that the trust otherwise first constituted a "qualified trust".

For this retroactive qualification to be made available to a pension trust, it must be established to the satisfaction of the Secretary of the Treasury or his delegate that three conditions have been met. First, he must be satisfied that the trust was created under a collective bargaining agreement with two or more employers who are not related. This provision is made available only in the case of multiemployer plans because it is believed that only these plans involve the substantial delay after the bargaining agreement before it is possible to determine the schedule of benefits for the employees. Moreover, present law already provides that single employer plans may be retroactively qualified to the beginning of a year if the qualifications

are fully met by the 15th day of the third month following the close of a year.

Second, it must be shown to the satisfaction of the Secretary or his delegate that the disbursements made from the trust prior to actual qualification substantially meet the tests under which the pension plan subsequently qualifies. Minor variations, not basically discriminatory in character, for this purpose may be ignored.

Third, the Secretary or his delegate must be satisfied that prior to the time the trust constituted a qualified plan the contributions made to this trust were not used in a manner which would jeopardize the interests of the beneficiaries.

These are essentially the same conditions which previously, when plans were considered on an individual basis, Congress has required to be met before retroactive approval was accorded these plans.

(*c*)(*i*) *Effective date.*—This provision is to apply retroactively back to what was the general effective date of the Internal Revenue Code of 1954; namely, taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954.

(*d*) *Revenue effect.*—It is believed that this provision will result in a negligible loss of revenue.

25. Qualified pension, etc., plan coverage for employees of foreign subsidiaries and domestic subsidiaries operating abroad (sec. 221 of the bill and secs. 406 and 407 of the code)

(*a*) *Present law.*—Under present law, a domestic corporation may extend old-age and survivors insurance coverage to U.S. citizens employed by its foreign subsidiaries. This social security coverage can be provided by agreements between the parent company and the Secretary of the Treasury or his delegate. This coverage is available only to U.S. citizens employed by foreign subsidiaries in which the domestic corporation has at least a 20-percent voting stock interest or a foreign subsidiary of such a foreign subsidiary if the first subsidiary has at least a 50-percent voting stock interest in the second. Of course, U.S. citizens in a domestic corporation, even though that domestic corporation is operating abroad, also are covered under present law for social security purposes.

There is no method comparable to the social security agreement referred to above for covering under a domestic corporation's qualified pension profit-sharing stock bonus, annuity, or bond purchase plan the U.S. citizens who are employees of its foreign subsidiaries. If a U.S. citizen becomes an employee of the foreign subsidiary, he is no longer eligible to participate in the pension or profit-sharing plan of the domestic parent corporation. Moreover, the foreign subsidiary corporation cannot establish a similar pension, etc., plan and obtain qualifications from the Internal Revenue Service unless it includes in this plan the foreign nationals on its payroll on a nondiscriminatory basis. Where the plan is not qualified, the U.S. citizens of such a foreign subsidiary under present law would be currently taxable on any contributions made by the foreign subsidiary to a pension or profit-sharing plan to which they had nonforfeitable rights.

Similarly, it has been held by some Internal Revenue offices that a domestic corporation operating abroad through branches cannot obtain qualified status plans which provide coverage for U.S. citizens

who are employees of the domestic corporation, unless it also provides nondiscriminatory coverage for the foreign employees on its payroll.

(*b*) *General reasons for provision.*—Your committee believes that it should be possible to cover under qualified plans U.S. citizens who are employees of foreign subsidiaries in substantially the same manner as it is possible to cover them by agreement under present law for social security purposes. It is believed that it should be possible to cover the U.S. citizens under a qualified plan for U.S. tax purposes without also covering the foreign nationals of the foreign subsidiary under such a plan. The foreign nationals usually are interested in different patterns of retirement benefits depending upon their own local custom; on the other hand, the U.S. citizen employed by the foreign subsidiary has close economic and personal ties with the United States, expects to return home, and may well wish to continue coverage under a qualified plan of the domestic parent corporation under which he was covered before becoming an employee of the foreign subsidiary.

The problem is substantially similar in the case of U.S. citizens employed abroad by foreign branches of domestic subsidiaries. They are covered for social security purposes and should in your committee's view have an opportunity to be covered under qualified plans in the same way as is proposed in the case of employees of foreign subsidiaries of domestic corporations.

(*c*) *General explanation.*—For the reasons given above, your committee has added an amendment to the House bill providing that U.S. citizens who are employees of foreign subsidiaries of a domestic corporation may under certain circumstances be included for coverage under a qualified pension or annuity plan or profit-sharing or stock bonus or bond-purchase plan or stock bonus plan of the domestic corporation. Thus, contributions made to such a plan for the U.S. citizens employed abroad by the domestic corporation will not be taxable to the employee at the time of contribution even though his rights in the contribution are nonforfeitable and the qualified status of the plan will not be disturbed.

To qualify for this treatment, the individual involved must be a citizen of the United States and an employee of a foreign subsidiary of a domestic corporation. The domestic corporation in this case must have entered into an agreement with the Treasury Department to cover for social security purposes the U.S. citizens who are employees of the foreign corporation involved, and the pension, profit-sharing or stock bonus plan of the domestic corporation must provide coverage for employees of all of its foreign subsidiaries with which it has entered into an agreement to provide social security coverage. In addition the individual involved must not be covered under any other employer's funded plan of deferred compensation such as a pension or profit-sharing or stock bonus plan (qualified or not) with respect to the compensation he receives from the foreign subsidiary. A foreign subsidiary for this purpose is defined in the same manner as is provided for in the case of social security coverage of U.S. citizens who are employees of a foreign subsidiary. Thus, the parent corporation must have a 20-percent voting stock interest in the foreign subsidiary. Also covered are subsidiaries of such a foreign subsidiary where the first foreign subsidiary has at least a 50-percent voting stock interest in the second.

Your committee's amendment also provides that employees of a domestic subsidiary of a domestic parent corporation may be covered

under the domestic parent corporation's pension or annuity plan, profit-sharing plan, stock bonus or bond-purchase plan where the individual involved is a U.S. citizen and the domestic subsidiary's operation is largely through foreign branches. Here, of course, coverage for social security purposes is automatically provided since the subsidiary corporation involved is a domestic corporation. In other respects, however, the conditions which must be met are substantially the same as those specified above in the case of the foreign subsidiary. Thus, the pension or profit-sharing plan of the domestic parent corporation must provide for coverage for employees of all domestic subsidiaries (meeting the definition specified below) who are citizens of the United States. Also the compensation paid by the domestic subsidiary operating abroad to the employee must not be covered under any other funded pension, profit-sharing or other type of plan of deferred compensation.

The definition of a domestic subsidiary whose operations are largely foreign approximates the requirements under present law specified with respect to Western Hemisphere trade corporations except that there is no geographical limitation to the Western Hemisphere. Thus, 95 percent or more of its gross income for the taxable year and 2 prior years must be derived from sources without the United States and 90 percent or more of its gross income for this same period must be derived from the active conduct of a trade or business. In addition, its voting stock must be held to the extent of 80 percent or more by the domestic parent corporation (as contrasted to the 20-percent requirement in the case of the foreign subsidiary).

Although the U.S. citizen who is an employee of either the foreign subsidiary or the domestic subsidiaries operating abroad is to receive the benefit of tax postponement with respect to contributions made by the domestic parent corporation to the qualified pension or profit-sharing plan, the domestic parent corporation is not to receive a deduction for its contribution to the plan since this is compensation provided with respect to an employee of its subsidiary. Generally, the domestic parent corporation, to the extent of these contributions, will be treated as having made a contribution of capital to its foreign subsidiary or domestic subsidiary operating abroad. Then this amount will be treated as a deduction to the subsidiary (to the extent it is subject to U.S. tax). In any event, this amount will decrease the earnings and profits account of the subsidiary.

Although the deduction in this case is denied the domestic parent corporation for purposes of all other tests as to the status of the pension or profit-sharing fund, including funding for back years as to which no benefits were provided under any funded plan of deferred compensation, the contribution to the plan with respect to these U.S. citizens employed abroad will be treated in the same manner as other contributions to the fund by the domestic parent corporation. The individual involved will also be treated as if he were an employee of the domestic parent corporation for purposes of the annuity provisions of the code (sec. 72 (d), (f)), the section providing up to $5,000 of tax-free benefits upon an employee's death (sec. 101(b)) and for purposes of the treatment of annuities received under qualified plans for purposes of the estate and gift taxes (secs. 2039 and 2517).

In testing to be sure that a plan is not discriminatory, officers, shareholders, supervisory personnel, etc., of the subsidiary will be

treated as if they had the same status with respect to the domestic corporation, and the determination as to whether an individual is highly compensated or not will be made on the basis of what the individual's status would be if he were an employee of the domestic parent corporation. Similarly, what is treated as compensation to the employee for purposes of a qualified plan is to be determined on the basis of his compensation received from the foreign or domestic subsidiary corporation. If part of this compensation is received in foreign currency, this compensation will be valued under existing law for purposes of this provision.

(c)(i) *Effective date.*—The general effective date for these provisions is to be taxable years ending after December 31, 1963.

(d) *Revenue effect.*—It is expected that this provision will result in a negligible loss of revenue.

26. Employee stock options and purchase plans (sec. 222 of the bill and secs. 421–425 of the code)

(a) *Present law.*—Under present law, no income tax is imposed in the case of employee restricted stock options, either when the option is granted or at the time it is exercised. Instead, tax generally is imposed at the time the stock involved is sold by the employee. In the case of those stock options where the option price is at least 95 percent of the market price of the stock at the time the option is granted, the entire amount of any gain realized by the employee at the time he sells the stock is treated as capital gain. Where the stock option price is between 85 and 95 percent of the market price at the time the option is granted, the difference between the option price and the market value of stock at the time of the grant of the option is treated as ordinary income. However, this ordinary income is not realized for tax purposes until the employee sells the stock.[1] Any additional gain at the time the stock is sold in such cases is treated as capital gain. In the case of these restricted stock options, employers are not allowed any deduction for the amount of the gain realized by the employee, whether this gain is treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must be at least 85 percent of the market price of the stock at the time the option was granted, the stock and/or the option must be held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it is transferred to him, the option must not be transferable other than at death, the individual may not be a 10-percent shareholder in the corporation (unless the option price is at least 110 percent of the fair market value) and the option must not be for a period of more than 10 years.

(b) *General reasons for provisions.*—The administration recommended the repeal of the stock option provision altogether. This recommendation was made on the grounds that stock options were compensatory in nature and, therefore, should be treated in the same manner as wages and salaries. It was suggested that with the lower tax rates provided by this bill, compensation received in this manner no longer required special treatment.

[1] If the gain is less than the spread between the option price and the fair market value at the time the option is granted, this lesser amount is taxed as ordinary income.

The House, however, decided to continue the stock option provision because it believed that it is good for the economy for management of various businesses to have a stake in their successful operation. The House believed that this provides important incentives to expand and improve the profit positions of the companies involved. It was suggested that this is not only good for the specific business involved, but also for the economy as a whole. Despite the fact that the House continued the stock option provision, however, it was recognized that there are abuse situations in the present provisions which need correcting. The House bill was directed toward such corrections. Your committee is in accord with this position and has, therefore, with relatively minor changes retained the House bill.

Although the use of stock options generally is thought of in terms of providing incentives for key executives in a business, what are presently called restricted stock options also are used by some companies for an entirely different purpose. Some companies have made stock options available to all, or practically all, of their employees Taking advantage of the fact that the option may be granted at 85 percent of the market price they make discount sales of the stock to their employees generally. These are known as employee stock purchase plans. Where stock options are used in this manner, they are designed primarily as a means of raising capital; and, in such cases, the discounts from market price made available to the employees usually correspond approximately with the costs the company would otherwise incur in floating a new stock issue.

In practice, the House and your committee found that quite different features are required for key employee stock options and the discount purchase plans made available to employees generally. For that reason, the two types of options are placed in separate sections setting forth substantially different requirements for each. In the case of the key employee stock options or "qualified stock options" as they are called by the bill for future years—

1. The period over which the stock must be held has been increased to 3 years. This is designed to give assurance that the key employees actually are acquiring a "stake in the business" and are not merely turning the stock over as fast as the options can be exercised.

2. The maximum period of time over which an option may be outstanding has been reduced from 10 years to 5. It is recognized that stock options historically have a much greater value to the individual if the period of time over which they may be exercised is a long period, since over most 10-year periods stock values have risen. Thus, where the option may be exercised over a very long period of time, such as 10 years, its grant appears more closely associated with compensation and less directed toward the individual efforts of the employee involved. Furthermore, the purpose of the provisions is to encourage the acquisition of a proprietary interest in the business as quickly as possible.

3. The options must be issued at 100 percent of the market price rather than 85 percent (with a special rule where the price inadvertently is set below 100 percent). Closely associated with this also is the removal of the variable price stock option provision. These modifications are made to decrease the compensatory nature of the existing stock option provision and to place

greater emphasis on the employee's efforts to improve his company's business and thereby raise the price level of the stock.

4. Provisions have been added to limit the extent to which new options may be exercised where old options previously were issued, but had become less attractive than a new option because of a decline in the market price of the stock in the interval between the issuance of the two. Existing law already limits the resetting of options below the original price of issue where the stock has declined. This modification achieves the result intended, but not obtained, by existing law. Your committee has adjusted this House provision in two respects to eliminate what it believes were unintended, harsh results under the House bill.

5. Stockholder approval is required for stock option plans to give assurance that the benefits granted management in the case of these options is in accordance with the desires of the stockholders.

6. The bill also provides that stock options generally are not to be made available to employees with stockholdings of more than 5 percent (although to a limited extent, they may be made available in the case of small business to those with holdings up to 10 percent). Under present law, stock options may be granted to employees with stockholdings of more than 10 percent only at a price 10 percent above the market price. It was thought unnecessary to provide employees who are substantial stockholders with any incentive to improve the business since they already have a substantial stake in its successful operation.

In the case of the employee stock purchase plans, existing law is continued (in a separate section) without major modification. In this case, for example, employees will continue to be able to purchase stock through options at a price as low as 85 percent of the market price of the stock at the time the option is issued since these plans, as previously indicated, are in the nature of "discount" purchase plans. However, to qualify for treatment under the employee stock purchase plans, a series of new conditions must be met, designed primarily to establish that the purchase plans are made available without discrimination to most employees of the corporation.

(c) *General explanation of provisions.*—The bill divides the tax treatment of employee stock options and purchase plans into five provisions: First are the general rules applicable to both; second, the special rules applicable to qualified stock options (i.e., those for key employees which are granted after December 31, 1963, under your committee's amendments, or June 11, 1963, under the House bill) third, the special rules applicable to employee stock purchase plans (in general, those granted after the date specified above); fourth, restricted stock options (which cover both of the two categories mentioned immediately above but only for options issued before the specified date); and fifth, certain definitions and special rules applicable to stock option and stock purchase plans in both the past and the future. The material presented below deals first with qualified stock options and then with employee stock purchase plans. The provisions dealing with restricted stock options, which are only those options issued in the past, are covered by a continuation of existing law and are not dealt with here.

(c)(i) *Qualified stock options: tax treatment.*—Generally, in the case of qualified stock options, no income tax is imposed either at the time

the option is granted or at the time the option is exercised and the stock is transferred to the employee. Similarly, no business expense deduction is allowed to the employer corporation (or a parent or subsidiary of that corporation) at any time with respect to this option.

There is, however, an exception to the general rule that no tax is imposed at the time of the exercise of the option. As is indicated below, one of the requirements of a qualified option is that the price under the option is not to be less than the fair market value of the stock at the time the option is granted. An exception to this, however, is provided where there was an attempt made in good faith to price the option at the market value of the stock but the market value was underestimated. This, of course, would ordinarily occur only in the case of unlisted stock. In such cases the option will not be disqualified, but 1½ times the difference between the option price and what actually is the fair market value of the stock at the time the option is granted (or the difference between the option price and fair market value at the time of exercise, if this is smaller) is to be taxed as ordinary income at the time the option is exercised. This is intended to discourage any attempts at undervaluing the stock, without disqualifying the options where the undervaluation was unintentional.

Another limitation on a qualified stock option (set forth below) is that the stock must be held for at least 3 years. The bill provides that in those cases where it is not held for this 3-year period, the option will still be a qualified option, but the spread between the option price and the value of the stock at the time the option is exercised will be treated as ordinary income at the time the stock is sold. However, in such cases the employee will never be taxed on more than his gain. Thus, if the price of the stock has fallen since the time of the exercise of the option, the amount of the ordinary income will be limited to the difference between the option price and the actual price of the stock on the date of sale. Where the price of the stock at the time of sale is less than the option price, there will be no ordinary income and the difference between the option price and the price at which the stock is sold will be treated as a capital loss. On the other hand, if the stock is sold at a price which is higher than the price on the date the option was exercised, then in addition to the amount treated as ordinary income (the difference between the option price and value on the date of exercise) there will be an amount treated as a capital gain.

The determination of the type of capital gain, i.e., whether short term or long term will depend on the length of time the stock has been held. Thus, any gain where the stock has been held beyond the 3-year period specified with respect to qualified stock options will result in long-term gain with a 50-percent inclusion factor and a 25-percent maximum tax. Where the stock is disposed of in less than 3 years and, in addition to the amount treated as ordinary income, there is an amount treated as capital gain, this capital gain will be either short term (if the stock is held 6 months or less) or long term (if it is held more than 6 months).

As under present law, where the employee dies after having purchased the stock but before holding it for the specified period of time, this holding period is waived since there is no business reason for

requiring the estate or heir to hold the stock. Similarly, a requirement subsequently referred to that the individual must be in the employ of the corporation involved up to 3 months before the date. of exercise of the option also is waived in the case of the death of the employee before exercise.

A transfer to a trustee in bankruptcy (or a similar fiduciary) of shares of stock acquired under a qualified stock option is not considered to be a "disposition" of such share so there will be no ordinary income recognized at that time, although a capital gains tax may be due.

(c)(ii) Qualified stock options: conditions for qualification.—For an individual to receive full qualified stock option treatment, he must not sell (or otherwise dispose of) his stock within 3 years of the date of exercise of the stock option. As indicated previously, where all conditions but this one are met, tax is not imposed until the sale of the stock, but much or all of the tax imposed at that time, if this condition is not met, will be on the basis of ordinary income rather than capital gain. This condition is designed to give assurance that the key executive involved actually maintains a "stake in the business" and is not merely selling the stock shortly after he receives it, thus vitiating the principal purpose of stock options, and converting ordinary compensation into capital gain. This requirement, of course, is not a new idea since present law already requires the individual to hold the option, or stock, for at least 2 years and the stock alone for 6 months in order to receive restricted stock option treatment.

A second condition which must be met for the option to receive qualified stock option treatment is that the individual involved, for the entire time from the date of the granting of the option until 3 months before the date of the exercise of the option, must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of a corporation) which has assumed the option of another corporation as the result of a corporate reorganization, liquidation, etc. This provision differs only slightly from existing law, which requires that the individual be in the employment specified at the time of the granting of the option and on the day ending 3 months before the exercise of the option but does not require that he be in the specified employment in the intervening time. Of course, for this purpose, military leave or sick leave would not disqualify an individual.

In addition to the requirements referred to above, the terms of the option itself must also meet certain specified conditions in order to be eligible for qualified stock option treatment. They are as follows:

1. The option must be granted under a plan which specifies the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted. If the plan permits stock options to be granted to a class of employees, the class of employees must be described with sufficient particularity to allow the shareholders to make a meaningful decision concerning the plan. The use of a general term such as "key employees" is not a sufficient description of those eligible to receive options. Ordinarily any change in the aggregate number of shares which may be issued under the plan or the employees or class of employees eligible to receive such options will be treated as the adoption

of a new plan. No other change in the terms of a stock option plan will, however, be considered to be the adoption of a new plan.

2. The option must be granted within 10 years of the time the plan is adopted or approved by the stockholders, whichever is the earlier.

3. The option must by its terms be exercisable only within 5 years of the time it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. An exception to this provides that where the option price was less than the market price, but this was unintentional, then this condition is to be considered as met (although as previously indicated, a maximum of 1½ times any difference in price is taxed as ordinary income at the time of the exercise).

5. Generally the option by its terms is not to be exercisable while there is outstanding any qualified stock option or restricted stock option which was granted to the employee at an earlier time. The purpose of this provision is to prevent an individual from indirectly gaining an advantage by the employer in effect resetting the price at which an earlier option was issued by issuing a second option at the lower price. To prevent this a second option may not be exercised during the period the first option under its initial terms could have been exercised unless the first option itself is exercised. Thus, generally a cancellation of the first option will not enable the second option to be exercised any sooner. However, the bill as passed by the House provides that restricted stock options may be canceled any time before January 1, 1965, without affecting adversely the exercise of a qualified stock option subsequently issued. In addition, in the case of a restricted stock option which under its terms is made available to the employee only in installments over an extended period of time, the House bill provides that the installments which cannot yet be exercised at the time of the granting of a new qualified option are not to prevent the exercise of this second option so long as these installments cannot be exercised. Your committee has accepted this general rule of the House bill preventing the "resetting" of option prices and also has accepted the modifications in the general rule provided by the House bill. However, your committee has added two new modifications to provide for situations which it believes were overlooked by the House. First, where the option price for the new option is at least as high as the price of each of the outstanding, previously issued options to purchase the same stock (whether these prior options were qualified options or restricted options), this "reset" rule is not to apply; i.e., the new stock option in such a case can be exercised before the outstanding options. Second, your committee has provided that where an option under the terms under which it was granted is not immediately exercisable in full, the employer can permit the exercise date for any or all of the remaining installments of the options to be accelerated without this change being considered a "modification" which would require a new option price for the option for it to continue to constitute a qualified (or restricted) option. Both of these modifications made by your committee continue the intent of the House provision, in that neither permits the taxpayer to exercise a new option at a lower price than his old option until the old option has been exercised or lapsed. It was thought, however, that there was no need to deny the right to exercise the second option in those

cases where the taxpayer could gain no price advantage from this. Similarly, it was thought that there was no reason why the installments on the first option should not be accelerated where the inability to exercise these installments was preventing the exercise of the new option.[1]

6. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by him. This provision is the same as under present law.

7. The employee, immediately after the option is granted, must not own stock representing more than 5 percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. In the case of small businesses, however, the employee may own up to 10 percent of the voting power or value of the stock before being disqualified. For a corporation with equity capital of less than $1 million, this percentage is to be 10 percent and for one with equity capital of $2 million it is to be 5 percent. Between these two levels of equity capital the allowable percentage decreases gradually from the 10-percent level for a company with $1 million of equity capital down to the 5-percent level for a corporation with equity capital of $2 million or more. Equity capital for this purpose is the assets of the corporation, adjusted for any change in their basis, less any indebtedness of the corporation. Where a parent or subsidiary also are involved, adjustments are made to delete intercorporate ownership. For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, wife, ancestors, and lineal descendants. Stock owned directly or indirectly by a corporation, partnership, estate, or trust for this purpose is considered as being owned proportionately by shareholders, partners, or beneficiaries.

(*c*)(*iii*) *Employee stock purchase plans; tax treatment.*—As indicated previously, except for the addition of the nondiscrimination requirement (and the requiring of stockholder approval) the tax treatment of employee stock purchase plans continues to be substantially similar to the tax treatment of restricted stock options under present law. Thus, as under present law, no income is to be reported by the employee either at the time the option is granted or at the time it is exercised. Similarly, no deduction is available to the employer corporation with respect to the employee stock purchase plan.

As under present law, under these purchase plans the option may be issued at a price as low as 85 percent of the market value of the stock at the time of the grant. Where this is done, this spread between the option price and the market value at the time the option is granted, upon the subsequent sale of the stock by the employee or upon the employee's death is treated as ordinary income. However, in no event is the amount to be taxed to the individual as ordinary income to exceed the gain realized on the stock at the time of its disposition.

In addition, ordinary income in the case of employee stock purchase plans may arise where the stock is disposed of before the expiration of the applicable holding period. As under present law, the option and/or stock must be held for a period of at least 2 years and the stock itself held for a period of at least 6 months. Where this holding

[1] This latter rule, of course. applies whether or not a second option is issued; but it is believed that it will have a primary impact in cases of this type.

period is not complied with, then any spread between the option price and the price of the stock at the time the option is exercised will be treated as ordinary income when the stock is sold or otherwise disposed of. As under present law, the specified amount is ordinary income without regard to whether this is greater or less than the gain realized on the stock at the time of the sale. Where the gain otherwise realized is less than this amount treated as ordinary income, the specified amount is still treated as ordinary income but a capital loss is recognized equal to the difference between the market value of the stock at the time of exercise and the sales price of the stock. Apart from these two cases where ordinary income may be realized any other gain recognized on the sale of purchase plan stock results in capital gain.

(*c*)(*iv*) *Employee stock purchase plans; conditions for qualifications.*— As indicated above, to qualify for purchase plan treatment, the stock in these cases must not be disposed of within 2 years of the date of the granting of the option nor within 6 months after the transfer of the stock to the individual. This is a continuation of existing law.

In addition, the individual must at all times during the period beginning with the date of the granting of the option and ending 3 months prior to the date of exercise, be an employee of the corporation granting the option, a parent or subsidiary of the corporation, or a corporation (or parent or subsidiary of a corporation) which assumed this stock option as a result of a corporate reorganization, liquidation, etc. This provision is the same as that previously described in the case of qualified stock options. As indicated in the case of qualified stock options, this differs only slightly from existing law.

To qualify as an employee stock purchase plan, nine requirements must be met by the plan itself. Alternatively, all but the first two of these may, however, be met in the stock offering rather than the plan. These conditions are as follows:

1. As under present law, the plan must provide that the options are to be granted only to employees of the granted corporation or a parent or subsidiary.

2. The plan must be approved by the stockholders of the corporation granting the option within 12 months before or after the date the plan is adopted. This provision is a new requirement which is the same as that provided in the case of qualified stock options.

3. No employee can be granted an option if he owns 5 percent or more of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. Present law provides that employees having more than a 10-percent interest in a corporation may not obtain a restricted stock option at less than 110 percent of the market price of the stock.

4. A new provision designed to prevent discrimination provides that the options must be granted to all employees of the corporation except that there may be excluded one or more of the following four categories:

(*a*) Employees who have been employed less than 2 years;

(*b*) Employees who are part time and employed 20 hours or less per week;

(*c*) Employees whose customary employment is not for more than 5 months a year; and

(*d*) Officers, supervisory personnel, or highly compensated employees.

5. Another new provision designed to give assurance that these stock purchase plans are nondiscriminatory requires that all employees granted options have the same rights and privileges except that the amount of stock which may be purchased by any employee may be a uniform percentage of total compensation or regular or basic compensation and the plan may provide a maximum number or value of shares to be purchased.

6. Under the plan, the option price may not be less than 85 percent of the market value of the stock at the time the option is granted or not less than 85 percent of the market value of the stock at the time the option is exercised, whichever is the lesser. This restriction is similar to the limitations of present law although slightly more restrictive in some cases.

7. The period over which the option may be exercised cannot exceed 5 years where the option price is not less than 85 percent of the value of the stock at the time of the exercise or 27 months from the date of the grant of the option if the option price is at least in part determined on the basis of the price of the stock at the time the option is granted. Present law provides a 10-year period over which restricted stock options may be exercised but in practice it is understood that options issued under purchase plans generally have a much shorter period over which they may be exercised.

8. A new ceiling is provided to the effect that an employee may not purchase stock at an annual rate in excess of $25,000 a year. This restriction is provided since these plans are designed primarily for broad employee participation.

9. As under present law and in the case of the qualified stock options, the option must not be transferable by the individual other than at death and must be exercisable during the employee's life only by him.

(c)(v) *Reporting requirements.*—The bill provides that corporate employers are to report on the transfer of stock to an employee in the case of the newly established category of qualified stock options or present law restricted stock options. They also are to report on the sale of stock by the employee where stock is acquired under a stock purchase plan at a price less than the full value of the stock and where, under a restricted stock option, stock is purchased at a price between 85 and 95 percent of the value of the stock. In these latter two cases, the report of the sale of the stock by the employee is required since generally in these cases ordinary income tax will be payable by him. A copy of the form of the report going to the Government also is to be sent to the employee or former employee on or before January 31 after the year involved. In those cases where the employer is required to report on the sale of stock by the employee, he will not be expected to follow the ownership of the stock beyond the first transfer; e.g., if an employee transfers stock to a street name and then subsequently sells the stock, the employer will report the first transfer of the stock to the street name but will not be required to report the subsequent sale. Moreover, the reporting in these cases is merely to indicate the name, address, and account number of the individual employee involved and the stock sold by him.

(c)(vi) *Effective date.*—In the case of qualified options, the House bill generally provided that the new provisions were to apply to options granted to an individual after June 11, 1963. Your committee has amended this to provide that the new provisions with respect to

qualified options are to apply to options granted after December 31, 1963. A binding, written contract entered into before January 1, 1964, will not be considered as giving rise to options which must meet the "qualified option" test. Your committee has provided this new effective date to conform the effective date in this case with the general effective date provided under the bill for structural changes. In addition, it thought that it would be unfair to require taxpayers to conform to a new set of rules during an extended interval of time when the status of the proposals was still uncertain.

Of course, in a transaction which qualified as a tax-free reorganization, where a corporation entered into a binding obligation to assume outstanding restricted stock options previously granted by a corporation, any option which the acquiring corporation issues in assuming the outstanding options already granted by the acquired corporation, to the extent provided by present law, are considered as continuations of the old options and therefore will be considered as granted prior to January 1, 1964, and treated as restricted stock options rather than qualified stock options.

In the case of qualified options, your committee has also added a transition rule. This rule provides that an option which is issued after December 31, 1963, and before January 1, 1965, which does not meet the terms of a "qualified option", can be modified to meet these terms any time before January 1, 1965, without this modification being considered as giving rise to a new option requiring a new option price. This rule is intended to give taxpayers who have their plans already established, or who initially are not aware of the new provision, time to modify their stock options so that the new conditions are met without the options being disqualified as a result.

In the case of employee stock purchase plans, the new provisions under the House bill would apply to options granted after June 11, 1963. Your committee's bill has changed the effective date of the employee stock purchase provision so that it applies to options granted after December 31, 1963, in the same manner as in the case of the qualified options. These same reasons account for this change. Thus, the new employee stock purchase plan provision will apply generally to options granted after December 31, 1963. Existing law, however, will apply to options granted pursuant to a written plan adopted and approved before January 1, 1963, which at that time met the nondiscrimination requirements specified for employee stock purchase plans. A plan which was being administered in a way which did not discriminate in favor of officers, supervisory personnel, or highly compensated employees would continue to qualify as adopted and approved before January 1, 1964. Except for the date, this modification is the same as provided by the House bill. Thus, a plan (not otherwise being discriminatory) would be considered nondiscriminatory even though only full-time employees were covered (rather than those working 20 hours a week or more) or those with less than 6 months a year employment were omitted (rather than those with less than 5 months employment).

(*d*) *Revenue effect.*—The changes made by this provision are not expected to have any appreciable revenue effect. To the extent that the changes made above result in a reduction in stock options issued, this will increase deductions taken by corporations as they make deductible payments to employees in other forms.

27. Installment sales by dealers in personal property (sec. 223 of the bill and sec. 453(a) of the code)

(*a*) *Present law.*—A taxpayer using installment sale reporting can defer income for tax purposes until payments are received under the contract (rather than treating the entire amount as income as of the time the sale is made). This provides the seller with funds with which to pay the tax, while at the same time giving him the immediate advantage of deductions attributable to the sale.

Prior to October 15, 1963, sales under revolving credit plans were not recognized by the Treasury Department as installment sales for tax purposes because of certain differences between revolving credit plans and traditional installment sales. For instance, installment sales ordinarily involve a separate contract for each item of property purchased, providing for a series of payments specifically applicable to the purchase price of that piece of property. Usually the seller also retains some type of security interest in the property, until the property is paid for.

Revolving credit plans, on the other hand, do not involve separate sales contracts; under these plans any item in the store may be charged to the same account, and the seller does not retain any security interest in the property sold. The buyer has an option to pay his account in full within 30 days with no interest or finance charges. Alternatively, he may pay the account in installments and in this case a finance or service charge related to the unpaid balance of the account is added to the account each month. The buyer's regular payments are not specifically attributable to the purchase price of any single item but only go to reduce the unpaid balance on what may be the total purchase price of several items purchased at different times.

Despite these differences the U.S. district court in Massachusetts held revolving credit sales did qualify for installment sale treatment because, like installment sales they did retain the essential feature of an arrangement for the payment by the purchaser for the merchandise sold to him in a series of periodic payments of an agreed part or installment of the debt due (*Consolidated Dry Goods* v. *U.S.*, 180 F. Supp. 878; 1960). Shortly after this case was decided, the Internal Revenue Service announced that it would not follow the decision but was studying whether workable standards could be formulated for determining what part of revolving credit sales qualify as "sales on the installment plan" under existing law (Rev. Rul. 60–293, 1960–2 CB 163).

New regulations were issued by the Treasury Department on October 15, 1963 (TD 6682)[1] as the result of this study. They specifically provide for installment sale treatment of some amounts received under revolving credit plans, and include rules for determining the extent to which revolving credit plans qualify as installment sales. Broadly speaking, under these rules, a sample of revolving credit sales is taken from balances in customer accounts as of the billing dates for the last month of the seller's taxable year, and the percentage of sales in the sample accounts determined which (1) are of the type the revolving credit plan contemplates will be paid for in two or more installments and (2) actually are paid for in two or more installments. This percentage is then applied to total revolving

[1] C.B. 1963-2, 197.

sales accounts (after adjusting for sales of nonpersonal property) and the resulting amount is considered to be sales under the installment plan. This new regulation provides installment sale treatment for about 80 percent of revolving credit sales.

(*b*) *General reasons for provision.*—Your committee believes that although the new revolving credit regulations are commendable, they are difficult to apply. By providing in the statute that revolving credit sales are to qualify for income spreading, your committee's bill fully conforms the tax treatment of income under revolving credit plans and installment sales contracts. It also replaces the complex sampling procedure required by the regulations with a simple rule which will forestall compliance and administrative problems likely to arise under the regulations. It, of course, is not intended in making this change to exclude from installment sales treatment any sales or existing charges which are covered by existing law or regulations.

(*c*) *General explanation of provisions.*—This amendment adds definitions of two terms of the provision of present law which allows dealers in personal property to spread income from installment sales over the payout period under the installment contract. These terms are "installment plan" and "total contract price."

(*c*)(*i*) *Installment plan.*—The definition of "installment plan" would extend installment sale treatment to income received under any plan which provides for the payment by the purchaser for personal property sold to him in a series of periodic installments of an agreed part or installment of the debt due the seller. This definition would extend installment sale treatment to revolving credit sales of personal property which do not qualify under the new Treasury regulations. These include, principally, sales which are paid for in full on the first billing for the month of purchase, and sales for a month which in total amount to less than the monthly payment agreed to be paid by the purchaser under the revolving credit contract.

(*c*)(*ii*) *Total contract price.*—The proposed definition of "total contract price" would include finance and service charges with respect to revolving credit sales in the amount subject to installment sale treatment, thereby conforming to the treatment which is permitted in the case of the "time price differential" under traditional installment sale arrangements. Time price differentials are treated as part of the contract price and are not required to be included in income for tax purposes until the installments are received under the contract. Finance charges under revolving credit plans on the other hand, under the new regulation, may not be deferred until payments are received but must be accrued currently in the month to which they relate. The amendment does not change present law with respect to the treatment of amounts charged for service contracts or warranties.

(*c*)(*iii*) *Effective date.*—The amendments made by this provision are to apply with respect to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—These amendments are expected to result in a revenue loss of $140 million in the first full year of operation. However, this is a nonrecurring loss which is not repeated in subsequent years. The loss thereafter is expected to be about $10 million a year.

28. Timing of deductions and credits in certain cases where asserted liabilities are contested (sec. 224 of the bill and sec. 461 of the code)

(*a*) *Present law.*—Prior to the decision in the *Consolidated Edison* case [1] the Internal Revenue Service generally held that the payment of a contested tax liability resulted in the tax being considered as deductible even though the tax was still being vigorously denied and contested.[2] In the *Consolidated Edison* case decided in 1961 the Supreme Court held that a contested tax even when paid does not accrue as a deduction for income tax purposes until the contest is terminated. It was held that the tax was not deductible until after the contest was settled because all of the events which would determine whether or not the amount would ultimately have to be paid would not be determined until that time.

(*b*) *General reasons for provision.*—Although your committee does not question the legal doctrine laid down by the Supreme Court in the *Consolidated Edison* case, it believes that it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself. The objective of the reporting of .items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled. To the extent that deductions are allowed under this rule and then subsequently as a result of the contest the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined.

(*c*) *General explanation of provision.*—In view of the above considerations, your committee has amended the provision of existing law which specifies the year for the taking of deductions or credits generally. The amendment provides that if a taxpayer contests an asserted liability, such as a tax assessment, but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of the payment. This is based upon the assumption that the deduction or credit in this case would have been allowed in the year of payment, or perhaps in an earlier year when it would have been accrued, had there been no contest.

The treatment provided here can be illustrated by an example. Assume that in 1965 a $100 liability is asserted against a business which it pays at that time but contests the liability in a court action. Assume further that in 1967 the court action is settled for $80. Under present law, before the enactment of this provision, the deduction of $80 would be allowed in 1967. Under your committee's action, the taxpayer could claim a $100 deduction in 1965 but then in 1967 would

[1] *The United States* v. *Consolidated Edison Co. of New York Inc.*, 366 U.S. 380 (1961).

[2] This is the general rule laid down in *Chestnut Securities Co.* v. *United States* (62 F. Supp. 574 (1945)) which the Internal Revenue Service accepted in GCM 25298 (1947-2 CB 39).

have to take $20 into income except as provided in section 111 of the code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

In those cases where payment is not made until after the contest is settled, this does not prevent an accrual basis taxpayer from accruing the deduction or credit in an earlier year in which the contest is settled.

A similar amendment to that described above is also made to the Internal Revenue Code of 1939.

(*c*) (*i*) *Effective date.*—Generally, your committee's amendment to the 1954 code is to apply to payments made in taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the 1954 code. The amendment to the 1939 code applies to payments in taxable years to which that code applies.

The bill provides two exceptions to the general effective date rule specified above. First, if the taxpayer elects, he may continue to apply the old law with respect to taxable years beginning before January 1, 1964; i.e., he may claim the deduction or credit in the year in which the contest is settled rather than in the year in which the payment is made. If the taxpayer makes this election, he must do so within 1 year after the date of enactment of this bill and may not change this election after the expiration of this 1-year period. Moreover, to make this election the taxpayer must follow the rule of old law with respect to all payments made in a year beginning before January 1, 1964. This election may not be made with respect to a payment if the assessment of any deficiency arising as a result of this election would be barred with respect to any year. If this election is made with respect to a year which is not barred, the period for assessment of any deficiency arising from this election is to be kept open at least until 2 years after the date of enactment of this bill.

The second general exception to the general effective date is designed to keep a taxpayer from losing a deduction as a result of the enactment of this new provision. Thus, where for a past year no deduction or credit was allowed for a payment in a year before the contest with respect to it was settled and the refund or credit which would result from the deduction in the earlier year is barred, then the deduction is to be allowed in the year in which the contest is settled.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible decrease in revenues.

29. Interest on certain deferred payments (sec. 225 of the bill and sec. 483 of the code)

(*a*) *Present law.*—Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. In such cases the full difference between the cost or other basis for the property and the sales price usually is treated as capital gain to the seller. The buyer takes as a basis for the property the total sales price paid. For example, an individual taxpayer might sell a capital asset worth $1,000 for $1,300 payable over 10 years. In this case, if no mention is made that part of this payment is to be treated as interest, and the seller elects to report any gain on the installment basis, then each payment might be treated partly as a return of capital and partly as a capital gain. Over the 10-year period, the taxpayer would report $300 of

capital gain (assuming he had the full fair market value of $1,000 as his basis for the property). However, had $300 of this $1,300 payment been specified as an interest payment, this amount would have been ordinary income to the seller rather than capital gain. From the buyer's standpoint, the $300, if treated as part of the price of the property would be added to the basis of the property and, in the case of depreciable property be recoverable over the life of the property. He might also, if the property qualified, be eligible for an investment credit with respect to this $300. On the other hand, if this $300 were treated as interest, he could receive an interest deduction for this amount.

(b) *General reasons for provision.*—Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a nondepreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint. The House and your committee believe that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed.

(c) *General explanation of provision.*—The bill solves the problem referred to above by providing that where property is sold on an installment basis and part or all of the payments are due more than 1 year after the date of the sale or exchange—if no interest payments are specified or if "too low" interest payments are specified then part of each payment due after 6 months is to be treated as interest rather than as part of the sales price.

The interest rate to be used for purposes of this provision is to be a rate provided by regulations prescribed by the Secretary of the Treasury or his delegate. It is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person, in reasonably sound financial circumstances and with adequate security could be expected to borrow money from a bank. A rate of 5 percent, for example, would appear appropriate under existing circumstances.

With this interest rate specified by the Secretary, the proportion of each payment which would be considered an interest payment would be determined in the following manner: First, the present value of each installment payment would be determined, based upon the specified interest rate. Second, the deduction of the total of these present values from the total actual payments provided for under the contract then would give the total "unstated" interest payments under the contract.[1] Third, the total unstated interest then is assumed

[1] Where an interest rate was provided on the installments but at "too low" a rate, the present value of these interest payments would be determined along with the present value of the remainder of the payments as well. The unstated interest then would represent the present values, including the present values of such interest payments, deducted from total payments to be received under the contract excluding the interest payments.

to be spread pro rata over the total payments involved. Thus, if a specific payment represents one-tenth of the total payments, it would be assumed to include one-tenth of the total unstated interest.

For ease of administration and compliance, the regulations are to provide for the discounting of payments on a 6-month basis and are to ignore for this purpose any interest payments due within the first 6 months.

Where an installment contract provides for the payment of some interest, no unstated interest is to be computed unless the interest payments specified are at a rate more than 1 percent below the rate of interest payments which would be computed under this provision in the absence of those payments. Thus, if a 5-percent rate is specified by the Secretary, no unstated interest will be computed where the interest actually provided for under the contract is 4 percent or more. This represents a de minimis rule to prevent the application of this provision in those cases where interest variations are relatively minor.

For purposes of this provision, a payment for property in the form of a note, or other evidence of indebtedness of the purchaser, is not to be treated as a payment. To treat such amounts as payments would permit avoidance of this provision merely by exchanging non-interest-bearing forms of indebtedness for property. However, payments made on such indebtedness for purposes of this provision will be treated as if they were payments made on the contract itself.

Where, at the time of the sale or exchange, some or all of the payments are indefinite as to their size; for example where the payments are in part at least dependent upon future income derived from the property, the "unstated" interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is received, taking into account the time interval between the sale or exchange and the receipt of the payment. Also, where there is a change in the amount due under a contract, the "unstated" interest is to be recomputed at the time of each such change.

The bill specifies five situations in which this provision is not to apply: First, a de minimis rule as to price is provided. Thus, the provision will not apply unless the sale price of the property is in excess of $3,000. Second, in the case of the purchaser of the property, if any of the amounts involved are carrying charges which under present law from the standpoint of the purchaser are treated as interest, then, in the case of the purchaser, this provision is not to apply. Third, in the case of the seller, this provision is to apply only if some part of the gain from the sale or exchange of the property would be considered as gain from a capital asset or as gain from depreciable property. If the property is sold at a loss, this provision will nevertheless apply if, had there been a gain, some part of it would have been considered as gain from a capital asset or from depreciable property. Fourth, this provision is not to apply in the case of payments with respect to patents, which are treated as capital gain under present law. Fifth, the provision is not to apply where the property is exchanged for annuity payments which depend in whole or in part on the life expectancy of one or more individuals. In addition, this provision, of course, will not apply to payments such as those for timber, coal and iron ore (sec. 631) where the property is treated as sold as the timber is cut or the coal or iron ore is withdrawn, with the result that this is not treated as an installment contract.

(*c*) (*i*) *Effective date.*—Under the House bill this provision applies to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. Your committee has accepted the House effective date, but has provided one exception to it. It has provided that the new rule is not to apply to any sale or exchange made pursuant to a binding, written contract (including an irrevocable written option) entered into before July 1, 1963. This is consistent with the treatment provided elsewhere in the bill with respect to binding contracts.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

30. Personal holding companies (sec. 226 of the bill and secs. 541–543 of the code)

(*a*) *Present law.*—Under present law, a domestic personal holding company is taxed on its "undistributed personal holding company income" at a rate of 75 percent on the first $2,000 and 85 percent on the balance. This is in addition to the regular corporate income tax. In general terms, a personal holding company is a closely held corporation, most of whose income is derived from certain specified forms of passive income. The tax applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals. In addition, at least 80 percent of the corporation's gross income must be from what is defined as "personal holding company income."

In general terms, personal holding company income consists of income from what are considered to be passive forms of investment. Thus, it includes dividends, interest, and annuities. It also includes most royalties although mineral, oil, or gas royalties are included only where these royalties do not represent 50 percent or more of the company's gross income or where there are not trade or business deductions (other than compensation for personal services rendered by shareholders) equal to 15 percent or more of the company's gross income. Copyright royalties also are classified as personal holding company income if they represent less than 50 percent of the company's gross income or the business deductions (other than compensation for personal services rendered by shareholders) represent less than 50 percent of gross income or if other personal holding company income constitutes more than 10 percent of gross income. Thus, where these mineral, oil, gas, or copyright royalties represent the principal business of the company, this type of income is not classified as personal holding company income, if there also is evidence, in the form of sufficient business deductions, that the company is actively engaged in business. Rents also are classified as personal holding company income unless they represent 50 percent or more of the company's gross income. Other forms of income which are classified as personal holding company income includes income from stock, security, and commodity transactions (except in the case of dealers, producers, etc.), income from estates and trusts, income from personal service contracts where 25 percent or more of the stock of the corporation is owned directly or indirectly by the individual performing the services, and income from the right to use property of the corporation where 25 percent or more of the stock of the corporation is owned directly or indirectly by the person eligible to use the property. This latter category of income, however, is treated as personal holding

company income only where 10 percent or more of its income (without regard to this latter category or rents) is personal holding company income.

(*b*) *General reasons for provisions.*—Congress first imposed this tax on personal holding companies in 1934 in order to prevent the avoidance of the individual upper bracket surtax rates, by leaving what is essentially investment-type income in a corporate organization, subject to the lower corporate income tax. As indicated by the Administration, ways around the present personal holding company provisions have been found in several arrangements which permit the use of holding companies to avoid the individual income tax with respect to what is essentially investment-type income without the company involved being classified as a "personal holding company."

The principal avoidance devices involve the use of rental income, income from mineral operations, and certain capital gains which are not classified as personal holding company income as means of sheltering other investment income in such a manner that 80 percent or more of the company's gross income does not come within the technical definition of personal holding company income. In view of this, a number of modifications are made in the personal holding company provisions designed primarily to minimize the extent to which these special categories of income can be used to shelter clearly passive income. More detailed reasons for each of the various modifications provided by the bill are set forth in the explanation given below with respect to each of the modifications.

(*c*) *General explanation of provisions.*—The bill makes a series of modifications in the application of the personal holding company tax in the case of domestic corporations. However, except in the case of the dividends paid deduction in a liquidation, no change is made in the case of foreign personal holding companies. Most of the modifications described below are designed to eliminate various means by which holding companies have been avoiding classification as personal holding companies, although other problems are also dealt with.

(*c*)(*i*) *Tax rate of 70 percent.*—In view of the fact that this bill decreases the maximum tax rate applicable to individuals from 91 to 70 percent, your committee agrees with the House that the rates applicable to personal holding companies also should be lowered from the present rates of 75 percent on the first $2,000, and 85 percent on the excess, to what will be the new top individual income tax rate. Moreover, there appears to be no particular purpose for continuing the graduation in the personal holding company tax rate from 75 percent on the first $2,000 to 85 percent on the balance. In view of this, the bill provides that the personal holding company tax is to be 70 percent of the undistributed personal holding company income.

(*c*)(*ii*) *Decrease in 80-percent test.*—As previously indicated, one of the tests under present law provides that a company, to be a personal holding company, must derive 80 percent or more of its gross income from certain specified types of passive income, called personal holding company income. The bill decreases this 80-percent test to 60 percent. The decrease in this percentage is made because too many holding companies which are essentially holding companies of passive income have avoided the classification as such by holding their "personal holding company income" just slightly below the 80-percent limit. The more realistic 60-percent limit together with

other modifications described below will make the avoidance of this classification much more difficult for holding companies generally.

(*c*)(*iii*) *Adjusted ordinary gross income requirement.*—Under present law the 80-percent requirement referred to above is applied to the gross income of the corporation; i.e., if the gross income derived from certain specified passive sources equals 80 percent of the total gross income of the corporation, the corporation is classed as a personal holding company. This has made it possible for corporations to avoid personal holding company classification by seeking out types of income not characterized as passive, or of a personal holding company type, which give rise to a proportionately large amount of gross income even though leaving little, if any, income after the deductions attributable to this income. In this manner, various types of income have been used to shelter investment income and remove the company from the classification of a personal holding company. Rents, where they constitute more than 50 percent of the gross income of the corporation, are an example of a type of income used to shelter passive income, such as dividends. Mineral, oil, and gas income are the other principal examples of income which have been so used.

To overcome this problem, the bill adjusts downward the income from certain sources to the extent of certain specified deductions attributable to these types of income. Thus, the corporation will be a personal holding company if 60 percent of "adjusted" gross income consists of certain passive income. The adjustments are as follows:

1. In the case of gross income from rents, the deductions for depreciation and amortization, property taxes, interest, and rents paid to the extent attributable to the rental income received, are to be deducted from gross income.
2. In the case of mineral oil, and gas royalties and also in the case of working interests in oil or gas wells, the deductions attributable to these royalties or working interests for depreciation, amortization and depletion, property and severance taxes, interests and rents paid are to be deducted in computing this adjusted gross income. It should be clearly understood that although income from working interests in an oil and gas well for purposes of the 60-percent limitation are reduced by the deductions referred to above such income is itself never classified as personal holding company income.
3. Interest from U.S. Government bonds held for sale by a dealer who is making a primary market for these obligations and interest on condemnation awards, judgments and tax refunds also are to be excluded in arriving at adjusted gross income for this purpose. This adjustment serves a different purpose from the first two deductions in that it merely excludes from the base on which personal holding company income is computed this particular type of interest income which in reality is not passive in nature.

In applying the 60-percent test, not only is the total gross income adjusted downward by the amount of the deductions (or interest) referred to in the cases specified above, but also in determining the rental income and mineral, oil and gas income for purposes of this test, this income also is reduced by the specified reductions.

(*c*)(*iv*) *Capital gains.*—Under present law capital gains (other than capital gains attributable to stock, securities, or commodities) are

not treated as personal holding company income. All capital gains, however, are included in the gross income of the company for purposes of the 80-percent test. As in the case of the deductions referred to above, some companies have timed the realization of their capital gains income in such a manner as to keep their personal holding company income below the 80 percent. The bill avoids this problem by excluding all capital gains from the gross income in determining whether the 60-percent test is met. Thus, the test under the bill is based on adjusted ordinary gross income.

(c)(v) *Rental income.*—Under present law rental income is classified as personal holding company income only if it represents less than 50 percent of total gross income. This is based on the concept that where rental income represents the major activity, the activity involved is more likely to be of an active rather than passive character. The House bill retains this 50-percent test (applying it, however, to adjusted income from rents and to adjusted ordinary gross income) but adds a second test providing that rental income may be characterized as passive, or personal holding company income even where it represents 50 percent or more of the adjusted ordinary gross income if, apart from the rental income, more than 10 percent of the ordinary gross income (gross income excluding capital gains) of the company is personal holding company income. For this purpose, income derived from the use of corporate property by shareholders is not viewed as personal holding company income, but income from copyright royalties and the adjusted income from mineral, oil, and gas royalties is included for this purpose as personal holding company income.

Your committee has accepted the House changes in the 50-percent test with one modification. Your committee has made an amendment to this test with regard to rentals of tangible personal property retained by the lessee for three years or less. Under the amendment, in the case of such property, the income is not to be reduced by depreciation attributable to it for purposes of the 50-percent test and also for purposes of computing ordinary gross income. However, in the case of the provision in the House bill that the personal holding company income (apart from rent) may not exceed 10 percent of the ordinary gross income, your committee's amendments provide that the personal holding company income for this purpose may be reduced by dividends paid during the year, by dividends paid in the next year which are treated as if paid in the year in question, and by consent dividends. Your committee believes that this prevents the 10-percent rule from working harshly where the personal holding company income other than rents may exceed 10 percent of ordinary gross income, perhaps by only a small amount but under the House bill, nevertheless, result in the entire amount of rental income being classified as personal holding company income. Your committee's amendment in effect permits taxpayers to meet the 10-percent test after dividend payments (or amounts treated as paid in dividends). At the same time it gives assurance that the personal holding company income (apart from rent) sheltered in the company may not exceed 10 percent of its ordinary gross income.

The fact that rental income, both in applying the 60-percent test and also in applying the 50-percent provision to the rental income itself, is determined on the basis of reducing rental income by depre-

ciation, amortization, property taxes, interest, and rents paid has already been noted above. However, as previously indicated, tangible personal property rented for three years or less is not reduced by depreciation attributable to it for purposes of these tests, under your committee's amendments.

(c)(vi) *Mineral, oil, and gas royalties.*—Under present law mineral, oil, and gas royalties are considered to be personal holding company income unless they represent 50 percent or more of the gross income of the company and unless the trade or business expense deductions (other than compensation for personal services rendered by shareholders) represent 15 percent or more of the gross income of the company. Thus, under present law, as in the case of rental income, mineral, oil, or gas royalties are treated as personal holding company income unless they represent the bulk of the company's income. However, in this case there also must be business expenses—indicating the active character of the business—constituting 15 percent or more of the gross income.

The bill retains these two tests but applies them on the basis of the adjusted ordinary gross income, thereby reducing, for this purpose, the income considered to be in these categories by depreciation, depletion, property and severance taxes, interest, and rent paid.

In addition, the bill adds another test which must be met in such cases for the mineral, oil, or gas royalty income to escape characterization as personal holding company income. The personal holding company income of the company, apart from this category of income (but including as such income that from copyright royalties and from rents), must not represent more than 10 percent of the ordinary gross income of the company. Thus, the personal holding company type income which mineral, oil, or gas royalty income may shelter even where this income represents the bulk of the income of the company must be relatively small; namely, less than 10 percent of ordinary gross income. Your committee has also added an amendment making it clear that income from mineral, oil, and gas royalties includes production payments and overriding royalties.

(c)(vii) *Copyright royalties.*—Under present law, copyright royalties also are considered to be personal holding company income unless they represent 50 percent or more of the total gross income. An additional test which must be met in order to escape such classification is that the personal holding company income, apart from the copyright royalty income, must not exceed 10 percent of the company's gross income and the trade or business expense deductions (other than those for compensation for personal services rendered by shareholders or for royalties paid to shareholders) must represent 50 percent or more of the company's gross income. This provision is modified by the bill in that the requirement that deductions equal at least 50 percent of gross income is changed to provide that they must equal 25 percent of ordinary gross income reduced by royalties paid and by depreciation deductions with respect to the copyrights.

(c)(viii) *Produced film rents.*—Under present law payments received from the distribution and exhibition of motion picture films are treated as rentals. As a result, under present law, a corporation may be formed by an individual who owns a motion picture negative and have its earnings treated as rents for purposes of the personal holding company tax. Since in such a case more than 50 percent of its gross

income would be considered to be from rents, there would be no personal holding company tax payable in this case.

To meet this problem, the bill provides that payments received from the use of, or the right to use, films generally will be characterized as copyright royalty income. Thus, such income will be classified as personal holding company income unless 50 percent or more of the company's ordinary income is from this source, not more than 10 percent of the company's ordinary gross income is personal holding company income, and the deductions properly allocable to this film income represent 25 percent or more of the gross income from this source reduced by royalties paid and depreciation taken.

The bill, however, retains what is essentially the treatment of present law for "produced film rents." Produced film rents are rents arising from an interest in a film acquired before the production of the film was substantially complete. It was thought that less severe tests should be applied in such cases because the participation in the production of the film in itself indicates an active business enterprise in this case. For produced film rent to escape characterization as personal holding company income, as under present law, these rents need constitute only 50 percent or more of the ordinary gross income of the company.

(c)(ix) Other types of income characterized as personal holding company income.—Compensation for the use of property by a shareholder, amounts received under a personal service contract, and income from estates and trusts continue to be classified as personal holding company income essentially to the same extent as under present law, except for the fact that capital gain income is not classified as part of gross income in applying the 10-percent test in the case of the use of corporate property by shareholders.

(c)(x) Personal finance companies.—Present law provides that certain types of companies are not to be classified as personal holding companies. These include, for example, banks, life insurance companies, and surety companies. Also excluded from such classification are certain types of personal finance companies. Under present law, there are four different types of personal finance companies which are excluded from the personal holding company category. These categories in general terms are as follows:

1. Licensed personal finance companies, 80 percent of whose gross income is interest from loans if at least 60 percent of their gross income is received from loans classified as "small loans" by State law (or $500 if there is no State law limit) and if the interest is not payable in advance and computed only on unpaid balances. In addition, loans to a person who is a 10-percent shareholder must not exceed $5,000 in principal amount. These frequently are known as "Russell Sage" type personal finance companies.

2. Other lending companies engaged in the small loan or consumer finance business, 80 percent of whose gross income consists of interest or similar charges on loans to individuals and income from 80-percent-owned subsidiaries which in turn themselves meet this test. In addition, at least 60 percent of the company's income must be from interest or similar charges made in accordance with small loan or consumer finance laws to individuals where the loans do not exceed the State specification for small

loans (or if there is no such limit, $1,500) and if the trade or business expenses of the company represent 15 percent or more of the company's gross income. These companies also must not have loans outstanding to shareholders, with a 10-percent interest or more, which exceed $5,000.

3. A loan or investment company (such as a Morris Plan bank), a substantial part of whose business consists of receiving funds not subject to check and evidenced by certificates of indebtedness or investment, and making loans and discounts. Here also loans to a person who is a 10-percent shareholder may not exceed $5,000 in principal amount.

4. A finance company actively engaged in purchasing or discounting accounts or notes receivable, or installment obligations, or in making loans secured by any of these or by tangible personal property, if at least 80 percent of its gross income is derived from such business. In addition, at least 60 percent of such a company's gross income must be derived from certain categories of income. These categories, in general, relate to business or factoring-type loans: such as purchasing or discounting accounts or notes receivable, or installment obligations arising out of the sale of goods or services by the borrower in his business; making loans for not more than 36 months to businesses where the amounts are secured by accounts or notes receivable or installment obligations of the type described above, or secured by warehouse receipts, bills of lading, inventories, chattel mortgages on property used in the borrower's trade or business, etc. In the case of these companies, the trade or business expense deductions must represent at least 15 percent of the gross income of the company, and loans to those who are 10-percent shareholders in such company must not exceed $5,000 in principal amount.

In the interest of simplification, the House substituted one exclusion for the four now provided these categories of lending or finance companies. At the same time, it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make. It was suggested that this was properly a matter of regulation by State law governing these lending or finance businesses and that in any event the personal holding provisions do not apply to widely held corporations. In these latter cases only State law governs the type of loans which can be made.

In view of these considerations the House bill substituted for all four of the categories described above, one definition of a lending or finance company which is to be excluded from personal holding company tax treatment. This definition provided is designed first to assure that 60 percent of the company's income is from the active, regular conduct of a lending or finance business, and second that its personal holding company income [1] plus interest from U.S. obligations as a dealer in these obligations is not more than 20 percent of the company's ordinary income. These two limitations, and the restriction described below relating to business expense deductions, are designed to give assurance that the company is actively engaged in the lending or finance business and that not more than 20 percent of its remaining income is personal holding company income.

[1] For this purpose personal holding company income is computed without regard to income from subsidiaries qualifying under this exemption as lending businesses, but including gross income from rents royalties, produced film rents, and compensation for use of corporate property by shareholders.

Your committee has modified the requirement that not more than 20 percent of the company's ordinary income may constitute personal holding company income. The House bill permits a company engaged in the small loan business to satisfy the 20-percent test by excluding income which it receives from subsidiaries in the lending or finance business. Your committee's bill would extend this treatment to finance companies. Finally, a technical amendment makes it clear that income received for furnishing services and facilities to a lending or finance company is not to be treated as personal holding company income to members of the same affiliated group which meet the requirement of the exemption for the lending and finance companies, whether they are exempt from the personal holding company tax under the same or another provision.

In addition to 60- and 20-percent tests, the company must have certain business deductions described below, which are directly attributable to its lending or finance business equal to 15 percent of the ordinary gross income up to $500,000 plus 5 percent of the ordinary gross income between $500,000 and $1 million. This provision gives further assurance, as evidenced by the deductions of the company, that it is actively engaged in the lending or finance business. A fourth limitation applicable under present law in the case of all of the categories of lending companies denies the right to make loans to persons who are 10-percent shareholders to the extent of more than $5,000 a year in principal amounts.

The lending or finance business for purposes of this provision is defined as including the business of making loans and purchasing or discounting accounts receivable, notes, or installment obligations receivable, notes or installment obligations. It does not include, however, the making of loans or purchasing or discounting accounts receivable, notes or installment obligations if the remaining period to maturity on the loan or paper exceeds 60 months. It also does not include the making of loans evidenced by indebtedness issued in a series under a trust indenture and in registered form or with interest coupons attached. Your committee has amended the definition of a lending or finance business to make it clear that this includes the income from rendering services or making facilities available to another member of the same affiliated group which is also in the lending or finance business. This is provided because as a matter of economical operations, one company frequently hires the necessary personnel, acquires the appropriate facilities, and in accordance with the requirements of banks, borrows all of the money for the group. Then all of the corporations in the group pay a service charge for these services to the company performing them.

Business deductions for purposes of the 15-percent or 5-percent test include only those trade or business expense deductions which are deductible only by reason of section 162 or section 404 (other than compensation for personal services rendered by shareholders or members of their family), and depreciation deductions and deductions for real property taxes to the extent that the property to which they relate is used in the regular conduct of the lending or finance business. Trade or business expense deductions which are allowable specifically under other sections, such as the deduction for interest expense which is also allowable under section 163, are not included for purposes of the 15-percent or 5-percent test.

(c)(*xi*) *Liquidating dividends.*—Under present law, the 75- or 85-percent tax (70 percent under the bill) on personal holding companies applies only to the undistributed personal holding company income. Thus, this tax is applied after dividend distributions are taken into account. Included among the amounts treated as dividends eligible for the dividends paid deduction are distributions in liquidation to the extent of the accumulated earnings and profits. As a result, in the year of the liquidation of a personal holding company there is no income subject to personal holding company tax for that year. Despite the fact that the distributions are treated as dividends to the personal holding company, its stockholders in that year receive this income and report it at capital gains rates.

Thus, under present law, a company which is a personal holding company may nevertheless avoid both the personal holding company tax and the ordinary income treatment to its shareholders with respect to the personal holding company income the year in which it liquidates.

A problem is also presented in the case of corporations where a subsidiary is liquidated and both the parent and the subsidiary corporation are personal holding companies. In such a case, if the earnings and profits of the subsidiary exceed its undistributable personal holding company income in the year of the liquidating distribution, the parent corporation may use the excess dividend paid deduction in computing its own dividend paid deduction, thereby reducing its own undistributed personal holding company income in the taxable year and also in the 2 succeeding taxable years.

The bill meets these problems by limiting the application of section 562(b) to companies other than personal holding companies or foreign personal holding companies. However, it is provided in section 316(b) that in the case of a complete liquidation of a personal holding company within a 24-month period after the adoption of the plan of liquidation, that the term "dividend" is to include any amounts distributed in this liquidation to other than corporate shareholders to the extent of its undistributed income (before any deductions for this amount) only if the corporation involved designates amounts as dividends (and so notifies the distributee). If the corporation does so designate the distributions as dividends the individuals receiving a liquidating distribution from the personal holding company must report the amount so distributed as a dividend in the year of receipt. The bill also provides that in the case of a foreign personal holding company, the amount included in a United States shareholder's income is not to be diminished by any liquidating distributions made during the year.

An amendment is also made to the code which provides in the case of corporate distributees that where a complete liquidation of a personal holding company occurs within 24 months after the adoption of the plan of liquidation, the distribution is to be treated as a dividend for purposes of the personal holding company tax only to the extent of the corporate distributee's share of the undistributed personal holding company income for the taxable year of the distribution. Thus, the dividends paid deduction is allowed to a personal holding company only to the extent of the undistributed income for the taxable year and with respect to noncorporate distributees, only if such distributees treat such distribution as a dividend.

(c)(*xii*) *One-month liquidations.*—Your committee agrees with the House that while the tightening of the personal holding company

provisions as indicated in the prior discussion is desirable, nevertheless, it would be unfortunate to apply these provisions without any alternatives being available, to companies which in the past have not been classified as personal holding companies but which as a result of the new provision will for the first time find themselves subject to personal holding company tax. Your committee agrees that it would be unfair to require such companies to pay personal holding company tax if they are willing to liquidate. Although it is understood that some of these companies are willing to liquidate, nevertheless, it would represent a hardship under existing law for them to do so. The hardship arises from the fact that if they liquidate under the provisions of section 331 of the code, not only would the earnings and profits of such corporations be taxed to the shareholders at capital gains rates but also any other appreciation which has occurred in the value of the assets would be so taxed to them. Such companies in the absence of the new personal holding company provisions would face no necessity of liquidating and therefore under these circumstances no tax would now be paid with respect to these unrealized increases in value. The House and your committee believed it was appropriate therefore to forego the tax at this time on unrealized appreciations in value but to collect the capital gains tax on the earnings and profits distributed.

The bill, to facilitate the liquidation of these companies, provides a special provision (in sec. 333) applicable in the case of companies which, for one of the two most recent taxable years ending before December 31, 1963, were not personal holding companies under existing law, but would have been in that year if the new law provided by this bill had been in effect at that time. In such cases, the bill provides that any distribution in liquidation made by the corporation to the extent of the earnings and profits accumulated prior to the time of the liquidation is to be taxed at capital gains rates and that any remaining gain is to be recognized only to the extent of assets which consist of money or of stock or securities acquired by the corporation after December 31, 1962.

To be eligible for the treatment described above, the liquidation of one of these corporations must occur before January 1, 1967, under your committee's amendments (or January 1, 1966, under the House bill). The treatment described above providing capital gains treatment with respect to earnings and profits is not to apply with respect to any earnings and profits to which the corporation involved succeeds after December 31, 1963, under your committee's amendments (August 1, 1963, under the House bill) as a result of any corporate reorganization or as a result of a liquidation of a subsidiary of that corporation (except earnings and profits which on December 31, 1963 (August 1, 1963, under the House bill) constituted the earnings and profits of one of the companies described above or which were earned by such a company).

In addition to liquidations occurring before January 1, 1967, the capital gains treatment for earnings and profits accumulated before 1967 and nonrecognition of gain with respect to any other gains to the extent with respect to assets acquired before 1963 (and assets other than stock and securities acquired thereafter) the bill also makes this special liquidation treatment apply to certain corporations which liquidate after 1966 (1965 under the House bill). To qualify for

this post-1966 liquidation treatment, as in the prior case the corporation involved must be one which in at least one of the two most recent taxable years ending before December 31, 1963, was not a personal holding company under present law but would have been had the provisions of this bill been in effect with respect to that year. To qualify for this special post-1966 liquidation treatment, the corporation involved must also have incurred indebtedness in the period from December 31, 1933, to December 31, 1963 (August 1, 1963, under House bill), which is still outstanding, or incurred indebtedness after December 31, 1963 (August 1, 1963, under the House bill), which merely replaced indebtedness incurred before that time. So that the necessary records will be kept, the corporation must notify the Secretary that it may wish to liquidate under these provisions. This notice must be given before January 1, 1968 (January 1, 1967, under the House bill).

Cases have been called to the attention of your committee where corporations have entered into commitments to use their incomes to pay off such debts and where as a result it is difficult, if not impossible, for them to liquidate before this indebtedness is paid off. For that reason, the bill makes the liquidation treatment described above (but only with respect to earnings and profits accumulated before 1967) apply if the corporation liquidates in the year in which it either does pay off the pre-December 31, 1963, indebtedness or could have, if it had devoted all of its earnings or profits after 1963 to this purpose. In addition, it must also devote to this purpose any deductions for depreciation, amortization, or depletion since the funds in this case remain in the corporation and can be used to retire indebtedness. Thus, the special liquidation treatment described here with respect to liquidations occurring after 1966 is available only during the period of time necessary for the corporation to retire outstanding indebtedness out of earnings and profits and depreciation allowances.

Your committee has added an amendment providing that where a corporation believes that it is one of these "would have been" corporations eligible for the special liquidation treatment under section 333, if it subsequently is determined that it did not qualify for this treatment, the liquidation will, nevertheless, be treated as occurring under section 333 unless in the election it was indicated that it was made under section 333 only on the assumption that the new treatment would be available. Where the shareholders indicate that they made the election on this assumption, section 331 will apply if other requirements for the use of this liquidation section had been complied with.

(c)(xiii) Postponement of new personal holding company provisions for certain corporations.—To encourage the liquidation of companies which are not now personal holding companies but would become so as a result of the new provisions, a provision is added by the bill to the effect that such companies, if they liquidate before January 1, 1966, will not be subjected to the new personal holding company provisions provided by this bill. They will, however, have available to them the special liquidation provisions described immediately above and will be subject to the rules specified in the prior heading with respect to the dividends paid deduction. In addition, this provision will not apply in the case of the liquidation of a subsidiary corporation under section 332 unless before the 91st day after the last distribution by the subsidiary the parent corporation also is liquidated and both of these events occur before January 1, 1966.

(*c*)(*xiv*) *Deduction for amortization of indebtedness.*—In 1934, when the personal holding company provision was first adopted, Congress provided that indebtedness incurred before 1934 by a company which subsequently became a personal holding company would receive a special debt amortization deduction in computing its personal holding company tax. It was provided that to the extent that this debt was paid off, or amounts were set aside to pay off this debt, the tax base for purposes of the personal holding company tax was to be reduced by the amount of the amortization payments. Thus, these amortization payments were treated for purposes of the personal holding tax as deductions in the same manner as dividend distributions to shareholders.

The bill adds a similar provision for indebtedness incurred after December 31, 1933, and before January 1, 1964 (August 1, 1963, under the House bill), in the case of corporations which were not personal holding companies in one of the 2 most recent taxable years ending before December 31, 1963, but would have been had the new personal holding company provision been in effect at that time.

Qualified indebtedness for purposes of this provision includes not only the debt outstanding before January 1, 1964 (August 1, 1963, under the House bill), but also debt which has replaced that outstanding before January 1, 1964 (if the special amortization deduction has not already been taken for the repayment of the old debt). Thus, short-term bank loans, for example, which are renewed at intervals will not be disqualified for purposes of this amortization deduction if the taxpayer elects not to deduct the payment of the prior loan. In addition to deductions for actual payments, deductions are also permitted for amounts (if reasonable) which are irrevocably set aside to pay off a debt which may be payable at some future date.

The deduction for indebtedness under this provision is to be reduced by any deduction which the company receives for depreciation, amortization, or depletion, and for any deduction (in computing undistributed personal holding company income) for net long-term capital gains. These deductions are disallowed since the funds represented by them can be used by the corporation to pay off indebtedness in the same manner as the earnings and profits of the corporation. Any of these deductions not used in 1 year are carried forward for this purpose and used in a subsequent year. A special provision provides that where depreciable or depletable property which would give rise to this cutback in the indebtedness provision is disposed of after December 31, 1963, then to the extent the basis of the property disposed of exceeds the indebtedness which was transferred at the time of the same disposition the qualified indebtedness for which a deduction may subsequently be taken is reduced.

(*c*)(*xv*) *Effective dates.*—Generally the personal holding company provisions are made effective with respect to taxable years beginning after December 31, 1963. The dividends paid deduction modification and the liquidation provision, however, are to apply to distributions made in taxable years of the distributing corporation beginning after December 31, 1963.

(*d*) *Revenue effect.*—It is estimated that the personal holding company provision will result in a revenue increase of $15 million a year in a full year of operation.

31. Treatment of property in the case of oil and gas wells (sec. 227 of the bill and sec. 614 of the code)

(*a*) *Present law.*—The percentage depletion deduction, in the case of oil and gas, is either 27½ percent, multiplied by the gross income from the "property" or, if less, 50 percent of the net income from the "property." As a result, what constitutes "property" is of considerable significance in determining the percentage depletion deduction available. To avoid any reduction in the 27½-percent deduction on gross income from the property, it frequently is desirable to combine wells having a high ratio of net income to gross income with those having a low ratio so that the 50 percent net income limitation will have little, or no, effect.

At one time each separate mineral deposit in a lease or fee acquisition was treated as a separate property. Subsequently, the administrative practice arose of permitting, at the taxpayer's option, the aggregation or combination of deposits in a single lease or acquisition (sometimes referred to as a single tract or parcel of land). In 1954, Congress permitted the aggregation of properties across lease lines so long as all the properties were in one "operating unit." This change was prompted by circumstances of the hard mineral industry but it also applied to the oil and gas industries as well. In 1958, Congress adopted detailed rules in the case of the hard minerals. In general these rules provided that operating mineral interests may be aggregated mine by mine and any number of mines may be aggregated so long as they are in a single operating unit. These rules, to the extent applicable to hard minerals remain in force. In the case of oil and gas, Congress in 1958 gave operators an option to use either the 1939 code "lease" rule or the 1954 code "operating unit" rule.

The law and the regulations in the case of the "operating unit" rule provide that it is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land, or in contiguous tracts or parcels of land, so long as the interests are a part of the same "operating unit." In defining the "operating unit," the regulations refer to operating mineral interests which are operated together for the purpose of producing minerals. With respect to each taxpayer what constitutes an "operating unit" must be determined on the basis of his own operations. The operating units may not be uniform in the various natural resources industries or in any one of the natural resource industries. Moreover, in the case of a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term "operating unit" refers, however, to a producing unit and not an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are—

(1) Common field or operating personnel;
(2) Common supply and maintenance facilities;
(3) Common processing or treatment plants; and
(4) Common storage facilities.

It is made clear that operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests or merely because the products of the interests are processed at the same treatment plant. Generally,

however, the determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(*b*) *General reasons for provision.*—There have been two major objections to the operating unit rule adopted in 1954 as applied to oil and gas. First, it has been difficult to determine what an operating unit is and this is a continuous source of controversy between taxpayers and the Government. The problem arises from the fact that the term "operating unit" apparently has no generally understood meaning within the oil and gas industries. Basically, it is a tax concept having no real business substance.

Second, the operating unit rule has proved objectionable because it gives taxpayers an opportunity to increase their percentage depletion deduction merely by choosing the best combination of high and low cost properties for purposes of this aggregation rule. This opportunity, of course, is available only to those large enough to have many diverse property interests. It is possible under this rule to include some leases or tracts of land within a large area and to omit others even though the latter may be contiguous to some of the property included, while other property included in the aggregation may be many miles away. Taxpayers, in fact, are contending that the term "operating unit" covers operations over widespread geographical areas, including substantial portions of several States.

To remove this controversy and also to delete this opportunity for larger companies to maximize their percentage depletion deductions by unrealistic grouping of properties, the bill for the future eliminates the operating unit aggregation rule in the case of oil and gas properties. No inferences are to be drawn from this, however, as to what constitutes an operating unit or as to what could properly be aggregated with respect to the period of time before this change is made. In place of the operating unit rule taxpayers, as was true before 1954, will be able to maintain separate deposits as separate properties or can combine some or all deposits falling within a single lease or acquisition. They will not, however, be able to combine different leases or acquisitions, except in the case of properties which are in a unitization agreement. In these latter cases the owners of the property have in effect exchanged their separate interests in their leases for undivided interests in the whole, with the result that all interests of a taxpayer in the unit become one property.

(*c*) *General explanation of provision.*—The operating unit rule of existing law provides that if a taxpayer owns two or more separate operating mineral interests which constitute all or a part of an operating unit, he may form one aggregation and treat as one property any two or more of these interests, treating as separate properties any interests which he does not include in this one aggregation. Separate operating mineral interests may be aggregated for this purpose whether or not they are in a single tract or parcel of land, or contiguous tracts or parcels. A taxpayer may not, however, form more than one aggregation within a single operating unit.

The bill repeals the rule described above for taxable years beginning after December 31, 1963, with respect to oil and gas. It substitutes in its place a rule which, in effect, restores the pre-1954 administrative practice. No longer will the aggregation of properties be permitted at the "operating unit" level. Except in the case of unitization agree-

ments discussed below, taxpayers may not aggregate oil and gas properties above the level of a separate lease or acquisition, or "separate tract or parcel of land" as referred to in the bill.

The general rule which will apply in the future is that all of the taxpayer's operating mineral interests in a separate lease or acquisition will be combined and treated as one property. However, the taxpayer may elect to treat separately operating mineral interests within a single lease or acquisition. Where he does this he may have either no combination, or one combination of mineral interests in that tract or parcel of land. If he has one combination, all other mineral interests not in that combination are treated as separate properties.

Where the taxpayer has elected to treat separately some or all of the operating mineral interests in a single lease or acquisition, and subsequently finds or acquires new interests in that property, the new interests, unless he elects otherwise, are to be treated as a part of the combination, if there is a combination, or as separate properties if there is no such combination.

The election to treat part or all of the operating mineral interests in a lease or acquisition as separate properties must be made at the time of the filing of the return for the first taxable year beginning after December 31, 1963, or if later, the first taxable year in which an expenditure for the development or operation of the operating mineral interest is made by the taxpayer after acquisition.

(*c*)(*i*) *Unitization or pooling arrangements.*—As previously indicated, a unitization or pooling agreement is to be an exception to the rule stated above. A unitization agreement arises where two or more taxpayers holding interests in separate tracts or parcels of land exchange their interests for an undivided interest in a larger area (either by formal conveyances or contractual arrangement). Such an agreement also arises where a taxpayer holding operating mineral interests in several leases enters into an arrangement to pay the lessors royalties based on an undivided share of the oil and gas from all the leases. The bill provides that in these cases all of the operating mineral interests of a taxpayer which participate in one of these unitization agreements are to be treated as a single property without regard to the rules specified above. This treatment applies to all compulsory unitization agreements required by State law and also to voluntary agreements which meet both of the following two tests:

> (1) The operating mineral interests must be in the same deposit or two or more deposits, the joint development or production of which is logical from the standpoint of geology, convenience, economy, or conservation; and
>
> (2) The operating mineral interests covered by the agreement must be in tracts or parcels of land which are either contiguous or in close proximity.

In making this determination under No. (1), tax benefits are not to be taken into account.

A special rule is provided in the case of unitization agreements entered into in taxable years beginning before January 1, 1964. In these cases, where for the last taxable year beginning before 1964 the taxpayer treated each interest as a separate property and if it is determined by law that this was the proper treatment, then the taxpayer may, if he so desires, continue to treat these interests as separate

properties despite the fact that they are in a unitization agreement.

(*c*)(*ii*) *"Unscrambling" of basis.*—In the past, because of the "operating unit" rule, taxpayers have aggregated two or more separate leases or acquisitions which under the new rules provided by this bill, they must treat separately. This means that any basis for these properties must be segregated or "unscrambled." In the great majority of the cases, it is understood that this will present no problem because of the fact that the entire basis of the property involved has already been written off by percentage depletion deductions. However, for those where some basis still remains, the bill provides two rules, either of which may be followed in "unscrambling" the basis of the operating mineral interests which for the future must be treated as separate properties. The first of these rules provides that any basis may be divided among the separate properties in accordance with the fair market value of each property. The second rule provides that taxpayers may take the adjusted basis of each property at the time it was first included in an aggregation and adjust this basis downward for adjustments reasonably attributable to the property so that the total of these adjusted bases equals the adjusted basis of the former aggregation.

(*c*)(*iii*) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This does not involve any change in elections for those already covered under the 1939 code rules (sec. 614(d)).

(*d*) *Revenue effect.*—It is expected that this provision will result in an annual increase of revenue of $40 million.

32. Treatment of iron ore royalties (sec. 228 of the bill and secs. 631(c), 1231(b), and 272 of the code)

(*a*) *Present law.*—Under present law, iron ore royalties give rise to ordinary income; against this, however, a depletion deduction of 15 percent may be taken.

In the case of coal royalties, however, where the property has been held over 6 months, present law provides that the excess of the amount realized from the disposal of the coal, over the adjusted depletion basis and the expenditures attributable to making and administering the contract and in preserving the economic interest retained in the contract, is to be treated as a capital gain. Where capital gain is realized from coal royalties, no deduction is allowed for percentage depletion or generally for the making and administering of the contract or the preservation of the economic interest in the contract.[1]

(*b*) *General reasons for provision.*—Your committee agrees with the House that the tax treatment now available with respect to coal royalties also should be extended to iron ore royalties as well. The capital gains treatment was made available in the case of coal royalties in part at least to encourage leasing, and therefore production, at a time when the coal industry was facing strong competition from other forms of fuel energy. Today, domestic iron ore production also

[1] Where the expenditures referred to above plus the adjusted depletion basis of the coal disposed of exceed the amount realized under the contract and are not used to offset other gains, a loss is allowed (if some income is realized under the contract).

generally is decreasing. In recent years, for example, iron ore production in the United States has been as follows:

	Thousands of long tons
1950	98, 045
1955	103, 003
1958	67, 709
1959	60, 276
1960	88, 784
1961	71, 329

Source: Department of Interior, Bureau of Mines, Minerals Yearbook.

The capital gains treatment provided by this bill should encourage domestic leasing of iron ore properties to operators, and therefore should improve the position of domestic iron ore production relative to foreign production.

Your committee has modified the House bill, however, to limit the capital gains treatment for iron ore royalties to domestic iron ore. In addition, it has denied capital gains treatment for these royalties where the person receiving the royalty and the person acquiring the iron ore are related persons or are owned or controlled directly or indirectly by the same interests.

(*c*) *General explanation of provision.*—The bill provides that, as in the case of the disposal of coal, where iron ore is disposed of after being held for more than 6 months by the owner under a contract in which the owner retains an economic interest in the iron ore, the difference beween the amount realized from the sale of the iron ore and certain costs is to be treated as a capital gain. An amendment made by your committee limits this treatment in the case of iron ore to that mined in the United States.

The costs taken into account for purposes of determining the gain are the cost of the property itself (adjusted downward for any depletion deduction taken) plus expenditures in the taxable year for making and administering the contract and the preservation of the economic interest retained under the contract. However, where these expenditures together with the adjusted basis of the property exceed the amount realized under the contract and are not used to offset other gains from the sale or exchange of "property used in the trade or business," a loss is to be recognized. Thus, the costs and expenses incurred by the taxpayer are to decrease the amount received in determining the amount treated as a capital gain.

The bill treats these iron ore royalties like coal royalties as "property used in the trade or business." As a result, if the gains from iron ore royalties plus the gains from other "property used in the trade or business" exceed the losses from the same type of property, the gain is to be treated as capital gain.

In obtaining this capital gains treatment for the iron ore royalty the lessor must forgo any depletion deduction with respect to his property (although his adjusted depletion basis is taken into account in computing his gain). In addition, he must generally forgo any deductions for expenditures attributable to the making and administering of the royalty contract and any expenditures attributable to the preservation of his economic interest in this contract. The primary exception to the denial of the deductions in this case is where these expenses plus the adjusted depletion basis for the iron ore disposed of

exceed the royalty payments received and are not offset against other gains. With respect to this excess, a loss is allowed.

The House bill provided in the case of iron ore, as in the case of coal under present law, that the capital gains treatment is not to apply to income realized by any owner as a coadventurer, partner, or principal in the mining of the coal or iron. The word "owner" here means any person who owns an economic interest in the coal or iron ore in place including a sublessor. Your committee has added an amendment which in the case of iron ore further restricts the availability of the capital gains treatment. Under your committee's amendment, the capital gains treatment will not be available where the owner of the interest in the iron ore and the operator are related, or where the two parties are owned or controlled directly or indirectly by the same interests. "Relationship" here is the same as the relationship which would result in the denial of a deduction for losses in the case of the sale of property under section 267 or 707(b).

The iron ore for this purpose is considered as being sold on the date the iron ore is mined.

(c)(i) *Effective date.*—As amended by your committee, the capital gains treatment provided by this provision is to apply to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in taxable years beginning after December 31, 1963. In the House bill, the capital gains treatment would have applied to all iron ore mined in taxable years beginning after December 31, 1963, even though amounts were received with respect to such iron ore in prior taxable years.

(d) *Revenue effect.*—This provision is expected to result in an annual loss of revenue of $5 million.

33. Insurance companies; mutualization distributions made in 1962 (sec. 229(a) of the bill and secs. 809(d)(11) and 809(g)(3) of the code)

(a) *Present law.*—The Life Insurance Company Income Tax Act of 1959 provided a special rule where a stock life insurance company is "mutualized," or converted into a mutual life insurance company, with a liquidating distribution being made to the shareholders and the remainder of the surplus and reserves being held for the benefit of policyholders in what then becomes a mutual company.

The 1959 act provided a special deduction for these liquidating payments to shareholders. To the extent of the excess of any gain from operations for the year in question over the taxable investment income, a deduction is allowed in computing the phase 2 tax of the insurance company for amounts paid out in one of these liquidating distributions to the shareholders. The distribution has to be under a mutualization plan adopted before January 1, 1958. This deduction in computing the phase 2 tax cannot result in any lower tax than if the 1957 law had applied in the year in question. In addition, this amount is treated as paid first out of capital and paid-in surplus, to the extent of this capital and paid-in surplus, with the result that no tax is likely to arise under phase 3 of the life insurance company tax in the case of these distributions.

The treatment described here was initially made available with respect to distributions in 1958 and 1959 but was subsequently (in Public Law 87–59)[1] extended to cover distributions in 1960 and 1961.

(b) *General reasons for the provision.*—The attention of your com-

[1] C. B. 1961-2, 308

mittee has been called to a case where a mutualization agreement was entered into before January 1, 1958, and the final distribution payment was authorized in 1961 but the distribution of these payments could not actually be made until 1962 because of the requirements of the State law involved. Your committee believes that liquidation payments made under these circumstances should be treated in the same manner as in the case of the mutualization liquidating payments made in prior years.

(c) *General explanation of provision.*—For the reasons given above, your committee has added an amendment to the bill providing that the special liquidating distributions rules provided by present law for the years 1958–61 under a mutualization agreement entered into before 1958 are also to apply to distributions in 1962. This will enable the company to receive a deduction for this amount (subject to applicable limitations) in computing its phase 2 tax and also to treat this amount for purposes of phase 3 as being made first out of capital and paid-in surplus, to the extent of such amounts, and only after that, is a part of this amount to be treated as a payment first out of the already tax-paid shareholders surplus account, to the extent of the balance of this account, and only then from the policyholders surplus account, withdrawals from which are subject to tax.

(c)(i) *Effective date.*—The amendment made by this provision is to apply to taxable years beginning after December 31, 1961.

(d) *Revenue effect.*—It is estimated that this provision will result in a negligible loss of revenue for 1 year.

34. Accrual of bond discount by certain insurance companies (sec. 229(b) of the bill and sec. 818(b) and sec. 822(d)(2) of the code)

(a) *Present law.*—Under existing law, prior to Rev. Rul. 60–210 (1960–1 CB 38), mutual fire and casualty insurance companies and life insurance companies amortized premiums and accrued discount on bonds purchased by them. In the case of State and local government bonds, these companies increased the amount of their deduction for tax-exempt interest by the amount of discount accrued by them. This had the effect of treating discount in the same manner as tax-exempt interest, without regard to whether the discount was on the original issue of the bond or whether it grew out of subsequent fluctuations in the market value of the bond.

Revenue ruling 60–210, issued May 31, 1960, draws a sharp distinction in tax treatment between "issue" discount and so-called "market" discount on State and local government bonds. Under this revenue ruling, in the case of issue discount, such discount continues to be treated as in the nature of tax-exempt interest, and the deduction for such interest continues to be increased by the amount of issue discount accrued each year. Market discount, on the other hand, although required to be accrued by these companies, no longer is allowed by the Internal Revenue Service to increase the deduction for tax-exempt interest. Thus market discount accrued by life insurance companies and by mutual fire and casualty insurance companies is taxed as ordinary income.

Stock fire and casualty insurance companies on the other hand, and corporations generally, are not required to accrue discount (either that arising at the time of issue or market) on bonds purchased at a discount by them. Rather these corporations treat market discount on both taxable and nontaxable bonds as capital gain (or loss)

when the bond is sold or disposed of by them and treat original issue discount on taxable bonds as ordinary income when it is realized.

The Revenue Act of 1962 further affected the tax treatment of discount on bonds purchased by mutual fire and casualty insurance companies (but not life insurance companies). Broadly speaking, it was the purpose of that act to treat mutual fire and casualty insurance companies more nearly like stock fire and casualty insurance companies for Federal income tax purposes. To accomplish this objective, mutual companies were taxed under a modified total income formula, which in effect converts accrued discount on bonds into an underwriting deduction. This effectively takes market discount out of the ordinary income tax base of these mutual companies and provides capital gain (or loss) treatment for market discount on both taxable and nontaxable bonds when the bonds are sold or disposed of by the mutual companies and treats original issue discount on taxable bonds as ordinary income as it is realized upon disposition. This treatment is identical to the treatment of discount by stock fire and casualty companies and other corporations. However, this treatment under the 1962 Revenue Act does not apply to all mutual fire and casualty insurance companies. Actually, it applies only to those companies which are subject to the modified total income tax.

Therefore, small mutual companies (those whose gross investment income, plus premiums, is between $150,000 and $500,000) which are taxed only on their investment profits must continue to treat accrued discount currently as ordinary income. In addition, life insurance companies must treat this discount currently as ordinary income.

(*b*) *General reasons for provisions.*—Your committee sees no reason for treating market discount on bonds owned by life insurance companies and by small mutual fire and casualty insurance companies as ordinary income when all other corporations, including all other insurance companies, are allowed capital gain treatment for such discount. Moreover, when the tax treatment of bond discount varies depending upon the type of business the bondholder may be engaged in, it is difficult for the bond market (particularly in the case of State or local government securities) to function normally, since the after-tax earnings on the bond will not be uniform.

Moreover, your committee desires to bring stability to an area of the tax law that has been unsettled since 1960. From 1942 until 1960 there was little question but that discount on tax-exempt bonds held by life insurance and mutual fire and casualty insurance companies, regardless of the source of the discount, was tax exempt. In 1960, however, the market portion of discount on such bonds was held by the Internal Revenue Service to be taxable as ordinary income. In 1962 larger mutual fire and casualty insurance companies (but not the smaller mutual fire and casualty companies and not life insurance companies) were provided capital gains treatment on their market discount. Under your committee's bill in the future, market discount on bonds held by insurance companies and other corporations will be taxed alike; that is, as capital gain when the bond is sold or redeemed.

(*c*) *General explanation of provision.*—This amendment provides that for taxable years beginning after December 31, 1962, market discount received by any insurance company will be taxed as a capital gain. This conforms the treatment of this discount in the case of

life insurance companies and small mutual fire and casualty companies with that presently accorded stock fire and casualty companies, and the larger mutual fire and casualty companies (under the Revenue Act of 1962) and corporations generally.

In the case of original issue discount, the amendment conforms the treatment by small mutual fire and casualty companies with the treatment of original issue discount received by stock fire and casualty, and larger mutual fire and casualty companies (under the Revenue Act of 1962). Under the amendment, this discount will be reported as ordinary income when it is realized upon disposition.

Life insurance companies, however, would continue (as under present law) to accrue original issue discount currently on both taxable and tax-exempt bonds.

(c)(i) *Effective date.*—The amendments made by this provision are to apply to taxable years beginning after December 31, 1962.

(d) *Revenue effect.*—This provision is expected to result in a negligible loss in revenue.

35. Contributions by certain insurance companies to qualified pension, etc., plans (sec. 229(c) of the bill and sec. 832(c)(10) of the code)

Under the Internal Revenue Code of 1939, deductions for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan were allowed under the same section (sec. 23(p)) as most other deductions from gross income. In the rearrangement made in the 1954 Code, however, the deduction for these contributions was transferred over to the subchapter relating to deferred compensation and pension, profit sharing, stock bonus plans, etc. However, the 1954 Code in the case of casualty insurance companies in providing for trade or business deductions, refers to deductions in part VI of subchapter B, relating to itemized deductions for individuals and corporations, unintentionally omitting the reference to section 404 wherein the deductions for contributions to qualified pension, etc., plans is provided under the 1954 Code.

To remove this clerical error in the 1954 Code, and to make it clear that deductions are allowed for contributions to a qualified pension, etc., trust in the case of these casualty insurance companies, your committee has added a provision to the bill containing an appropriate cross-reference to obtain this result. Thus, section 832(c)(10) of the code is amended by making specific reference to section 404 and following, which are the provisions relating to pension, profit sharing, stock bonus plans, etc.

The amendment made by this provision is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

36. Regulated investment companies: Time for mailing certain notices to shareholders (sec. 230(a) of the bill and secs. 852–855 of the code)

(a) *Present law.*—Under present law, companies may qualify as "regulated investment companies" if they meet certain tests set forth in the statute. In general, to qualify for this status, the bulk of a company's income must be derived from dividends, interest, and gains on the sale of stock or securities. In addition, to receive this treatment, a substantial portion of the company's assets must be in diversified stock investments rather than being concentrated in the stock of a single or a few companies. Where a company qualifies as a regulated

investment company, if it distributes at least 90 percent of its investment company income (excluding net long-term capital gains), then the company is taxed only on its undistributed income.

In addition, certain features of the tax law which generally would be applicable only to the company receiving the income, in the case of a "regulated investment company" may be passed through to its shareholders. In each of these cases, the present provisions of the Internal Revenue Code provide that the shareholder must be given notice with respect to these special tax features within 30 days after the close of the regulated investment company's taxable year.

(*b*) *General reasons for provision.*—This provision increases from 30 to 45 days after the close of a regulated investment company's taxable year the time accorded it for giving notices to its shareholders with respect to these special tax features. Your committee believes that the allowance of this additional 15-day period is desirable because the regulated investment companies have had difficulties in getting out their notices within the 30-day period. Moreover, since individuals generally are not required to file their individual income tax returns until the 15th day of the 4th month (rather than the 15th day of the 3d month of the year as at one time was the case) provision of this additional time for the regulated investment companies to submit these reports to their shareholders still leaves the shareholders with 2 months after the receipt of the notices before their tax returns need to be filed.

(*c*) *General explanation of provision.*—The various tax features with respect to which the regulated investment company under this bill is to be given 45 rather than 30 days after the end of the year for notice to its shareholders are as follows:

1. Under present law, dividends paid to shareholders of a regulated investment company may be designated as capital gain dividends to the extent of the excess of the net long-term capital gain of the regulated investment company over its net short-term capital loss (but only to the extent these amounts are paid out). In the case of these dividends, the company pays no tax but the shareholder includes the dividend in his income as a long-term capital gain. In this case, the company is to have until 45 days after the end of its taxable year to notify its shareholders as to the amount of the dividend (sec. 852(b)(3)(C)).

2. As an alternative to actually distributing net long term capital gains, a regulated investment company can report such capital gains and pay a 25-percent tax on this income. Then the shareholder may include his share of these capital gains in his income as long term capital gain and claim a tax credit for the tax paid by the regulated investment company. For this treatment to be available, the company must designate within 30 days after the close of the taxable year the amount to be so treated by each shareholder. This provision increases this period of time to 45 days (sec. 852(b)(3)(D)(i)).

3. Present law provides that where more than 50 percent of the value of a regulated investment company's assets consist of stock or securities in foreign corporations and certain other tests are met, then the regulated investment company may elect to treat as distributed to its shareholders any income, war profits, and excess profits taxes paid by it to a foreign country (or a possession of the United States). Where the company so elects, the shareholders of the company include the amount of these foreign (or possession) taxes in their income and

then either claim a deduction or foreign tax credit for these amounts. For this treatment to be available, notice must be mailed to the shareholders not later than 30 days after the close of the company's taxable year. The provision changes this 30-day period to a 45-day period (sec. 853(c)).

4. Existing law provides that where less than 75 percent of a regulated investment company's gross income represents dividend income, then the shareholder receiving a dividend from the regulated investment company is to treat the amount he receives as a dividend only in the ratio which the company's dividend income represents of its total gross income. Present law provides that a regulated investment company must supply its shareholders with written notices indicating how much of its income in these cases is to be treated as dividends. This written notice must be supplied the shareholder within 30 days of the close of the company's taxable year. This provision changes the 30-day period to a 45-day period (sec. 854(b)(2)).

5. Existing law provides that income may be treated as paid out in the year earned if a regulated investment company declares a dividend before the time specified by law for filing of its return for the year in question and distributes this dividend to its shareholders not later than at the time of the first regular dividend payment after the declaration. (The shareholder in such cases may take the income into account in the taxable year in which he receives the distribution.) For the dividends to be considered as paid out in the earlier year, notice under existing law with respect to such dividends must be made to the shareholders not later than 30 days after the close of the taxable year in which the distribution of the dividends is made. This provision changes the 30-day period to a 45-day period (sec. 855(c)).

(*c*)(*i*) *Effective date.*—The changes in the filing dates referred to above are to apply to taxable years of regulated investment companies ending on or after the date of enactment of this bill.

(*d*) *Revenue effect.*—It is expected that this provision will have no effect on revenues.

37. Regulated investment companies: Redemptions by unit investment trusts (sec. 230(b) of the bill and sec. 852(d) of the code)

(*a*) *Present law.*—Present law provides that mutual funds are to be treated for Federal income tax purposes as "regulated investment companies." To qualify for this treatment the corporations involved must have widely diversified investments largely consisting of stocks or bonds. Ninety percent or more of their ordinary income must also be paid out to their shareholders. Such corporations, however, pay tax on their net long term capital gain to the extent such capital gain is not distributed to the shareholders.

In some cases what are sometimes called unit investment trusts are also associated with a mutual fund. These unit investment trusts receive periodic payments from individuals and invest these funds usually in the stock of a single mutual fund. Under present law these unit investment trusts are themselves also classified as regulated investment companies.

(*b*) *General reasons for provision.*—A problem has arisen under present law where one investor liquidates his interest in one of these unit investment trusts. In such a case if the trust sells stock which it holds to make the liquidating distribution and the proceeds from the

sale are distributed to one investor it is possible to argue that the distribution is a "preferential dividend" (as defined in sec. 562(c)) and that for this reason it does not result in a dividends paid deduction for this amount to the trust (but only to the extent of the investor's allocable share of the gain). This would therefore result in a tax on the capital gain to the trust although it retained none of the capital gain in its possession.

(c) *General explanation of provision.*—To meet the problem described the bill provides that in the case of a redemption by the trust of the investor's stock (in whole or in part) the redemption will not be considered as preferential dividend. This amendment is not intended to have any effect on the law prior to the effective date of this provision.

(c)(*i*) *Effective date.*—This amendment applies to taxable years of regulated investment companies ending after December 31, 1963.

(*d*) *Revenue effect.*—It is expected that this provision will have a negligible effect on revenues.

38. Foreign tax credit with respect to certain foreign mineral income (sec. 231 of the bill and sec. 901(d) of the code)

(*a*) *Present law.*—Under present law, citizens of the United States and domestic corporations may treat foreign income, war profits, and excess profits taxes paid or accrued to a foreign country as a credit against their U.S. income tax otherwise payable. In addition to taxes paid directly by a U.S. taxpayer, domestic corporations are allowed a credit for foreign taxes paid by 10-percent-owned first tier foreign subsidiaries and by second tier foreign subsidiaries if 50 percent of their voting stock is owned by a 10-percent-owned first tier foreign subsidiary. Similar tax credits are allowed if so-called "tax haven" income is included in the gross income of a domestic corporate shareholder (under sec. 951).

Foreign taxes which may be allowed as a credit against U.S. tax are limited to the same proportion of the U.S. tax against which the credit is taken as the income from sources within each foreign country (the "per country" limitation), or alternatively all foreign countries (the "overall" limitation), bears to the entire taxable income of the taxpayer. Thus, if foreign tax on foreign source income of the taxpayer on a per-country or overall basis is equal to, or less than, the U.S. tax resulting from including the foreign source income in taxable income, the entire foreign tax is allowed as a credit. Except in the case of interest income which is not related to the taxpayer's foreign operations, computations of foreign and U.S. taxes on foreign source income, for purposes of the limitation on the foreign tax credit, are made without regard to the type of activity from which the income is derived. To the extent the foreign taxes on foreign source income exceed the U.S. income tax applicable to the same income, the excess foreign tax may be carried back 2 years and forward 5 years and be used as a credit against U.S. tax in those years to the extent the foreign tax credit limitation for these years exceeds the foreign tax credit otherwise allowable.

(*b*) *General reasons for provision.*—Under present law, U.S. taxpayers who extract minerals in foreign countries are allowed a deduction for percentage depletion in computing their U.S. income tax. Because of the allowance by the United States of percentage depletion to the mineral-producing industries, the U.S. tax payable on these operations is often lower than the foreign tax payable on the income

from the same operations. Although the rates of tax generally in the foreign country in which the mineral is extracted are not likely to be higher than ours, the fact is that they frequently do not allow a deduction for percentage depletion or grant it at a lesser rate than does the United States. To the extent foreign tax paid or accrued on foreign income derived from the extraction of minerals from mines, wells, or other natural deposits exceeds the U.S. tax on the same income, the excess foreign tax, under present provisions relating to the allowance of foreign tax credits, is available as a credit against U.S. tax otherwise payable on foreign source income from unrelated activities of the taxpayer in the same or other foreign countries.

To prevent continuance of this benefit, which is available only to U.S. taxpayers who are engaged in the business of operating foreign mines, wells, and other natural deposits, your committee has provided that excess foreign tax credits which are attributable to the allowance of percentage, rather than cost, depletion by the United States shall not be allowed as a tax credit against U.S. tax otherwise payable on the income from taxpayer's nonmineral foreign activities. For this purpose, however, the taxpayer's mineral income is to include income from refining, distribution, and retail sales of the mineral products as well as their extraction. This is set forth in more detail below. Treating these related activities in this manner is necessary to enable these companies to maintain their present competitive position with others engaged in mineral extraction abroad. On the other hand, however, since the foreign tax credit cannot offset income from domestic sources, this will have no effect on domestic production.

(c) *General explanation of provision.*—For purposes of computing foreign tax credits available to a U.S. citizen or domestic corporation who claims a deduction for percentage depletion, your committee's bill requires a taxpayer to divide his income into two parts: first, "mineral income" from sources without the United States, and second, income from all other sources.

For purposes of this provision, the bill defines "mineral income" as income derived from the extraction of minerals from mines, wells, or other natural deposits, income from the processing of such minerals into their primary products, and income from the transportation, distribution, and sale of the primary products derived from the mineral or of the mineral itself. Thus, for example, an integrated oil company would treat its entire income from the production of oil, income attributable to the refining of crude oil into gasoline, income from the distribution of gasoline to marketing outlets, and its income from retail sales of gasoline as mineral income. Similarly, income from the refining, distribution, and marketing of fuel oil by the taxpayer would also be treated as mineral income for this purpose, whether or not the oil sold was extracted by the taxpayer. However, income attributable to the manufacture, distribution, and marketing of petrochemicals is not to be treated as mineral income since your committee does not consider them to be primary products of oil. In addition to treating certain operating income as mineral income, taxpayers are permitted to treat dividends from corporations in which they own 5 percent or more of the voting stock as mineral income to the extent the dividend is attributable to mineral activities of the payor corporation. However, this rule only applies if the dividend is treated as income from sources without the United States for income tax purposes. Thus, for example, if a domestic oil company receives

a dividend from a foreign oil pipeline company in which it owns more than 5 percent of the voting stock at the time of the distribution, the domestic company may treat the dividend as "mineral income." The bill also provides that a taxpayer may treat the portion of his distributable share of income of a partnership as mineral income to the extent it is derived from foreign mineral activities of the partnership.

Once the income of a taxpayer is divided into the mineral and nonmineral categories, your committee's bill results in a disallowance of foreign taxes as a credit against U.S. tax to the extent the excess of foreign tax over U.S. tax on the mineral portion of the taxpayer's income is attributable to the allowance of percentage, rather than cost, depletion for U.S. income tax purposes. Under this rule, foreign and U.S. taxes may be compared on the foreign mineral income of the taxpayer as a whole under the overall limitation, or they may be compared on a per country basis. However, if a foreign tax is disallowed under this provision in the year paid or accrued, it is not permitted to be treated as a carry back or a carry forward to another taxable year.

This provision does not affect taxpayers who do not claim percentage depletion on income from extraction of foreign minerals. Moreover, it does not affect taxpayers who claim percentage depletion on such income for Federal income tax purposes if the foreign tax allocable to their foreign mineral income is equal to or less than the U.S. tax applicable to the same income assuming the taxpayer used cost, rather than percentage, depletion for U.S. tax purposes.

(*c*)(*i*) *Effective date.*—This provision applies with respect to the computation of foreign tax credits for taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

39. Sale of residence by employee (sec. 232 of the bill and sec. 1003 of the code)

(*a*) *Present law.*—Under present law, amounts received by transferred employees from their employers in reimbursement of "losses," selling commissions, and legal fees incident to the sale of a principal residence have been held to be as ordinary income. *Harris W. Bradley*, 39 T.C. 652 aff'd 324 F. 2d 610 (4th Cir. 1963).

Prior to the *Bradley* opinion the treatment of these reimbursements was governed by a 1947 opinion of the Tax Court which treated the reimbursed amount as part of the selling price of the old residence (*Schairer*, 9 T.C. 549). This had the effect of providing capital gains treatment on the reimbursed amount if there was an overall gain on the sale and if the proceeds were not reinvested in a new residence. If, on the other hand, there was a loss on the sale of the old residence, the reimbursement received from the employer was not taxed.

(*b*) *General reasons for provisions.*—Your committee believes that treating reimbursements for selling expenses and "market value losses" as part of the proceeds from the sale of the old residence if the sale occurs because of an employee's transfer to a new place of work recognizes the practical effects of the transaction and treats the employee much as if he had not been required to sell his home under forced circumstances.

These transfers may be for the convenience of the employer, not the

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employee, and they often occur unexpectedly. In these cases the employee may be unable to sell his residence on a normal market but must dispose of it promptly, often when market conditions are most unfavorable. In many cases an employer may transfer a great many of his employees at one time. This may have a depressing effect on the home market for which the employer is largely responsible, and his reimbursements of his employees' selling expenses is only equitable.

Your committee believes that in a case of this type the employees are likely to derive no economic advantage from the reimbursements from their employers and that as a result it is unfortunate to treat these reimbursements as compensation.

(c) *General explanation of provisions.*—For these reasons, your committee's bill treats reimbursements received by employees from their employers for selling expenses and market value losses arising from the "forced" sale of their residence (within a limited period from the employee's transfer to a new place of work) as an additional amount realized on the sale of the old residence. The provision limits the amount of reimbursement which may receive this treatment to the lesser of (A) the sales differential, or (B) 15 percent of the gross sales price of the old residence. "Sales differential" for this purpose means the amount by which (A) the appraised value of the old residence exceeds (B) the gross sales price of the old residence, reduced by the selling commissions, legal fees, and other expenses incident to the transfer of ownership of the old residence. In no event, however, is the appraised value, for purposes of (1) above, to exceed the fair market value of the old residence.

The bill further provides that this treatment is to apply only where the employee sells his house during the "forced sale" period; that is, the period beginning 90 days before and ending 180 days after the date on which he commences work as an employee at his new principal place of work. In addition, for the new rule to apply, the employee's commuting distance must, as in the case of the deduction for moving expenses under section 213 of the bill, be increased by at least 20 miles. This prevents the provision from applying to purely local moves. Finally, the individual receiving the reimbursement must have been an employee of the reimbursing employer for at least 6 months prior to the transfer.

(c)(i) *Illustrations.*—The following illustrations indicate the operation of this new provision in cases where the proceeds from the sale are not reinvested in a new residence and compares the result under the new provisions with the tax consequences under the Bradley decision.

Illustrations of provision

	Case A	Case B	Case C
Gross sales price of old residence	$30,000	$30,000	$30,000
Real estate commission	1,800	1,800	1,800
Legal fees incident to closing	200	200	200
Amount of reimbursement by employer	2,000	5,000	3,000
Average of appraisals of old residence	30,000	33,000	31,000
Fair market value of old residence	30,000	33,000	30,000
Cost of old residence	20,000	33,000	30,000
Tax consequences:			
1. Sec. 232:			
(a) Ordinary income	0	500	1,000
(b) Capital gain	10,000	0	0
2. Existing law, *Bradley* decision:			
(a) Ordinary income	2,000	5,000	3,000
(b) Capital gain	8,000	0	0

Case A indicates that where a residence is sold for its full value (which exceeds its cost), reimbursements received by the transferred employee for selling commissions and closing costs serve to increase the amount of capital gain otherwise realized on the sale.

Case B shows the application of the 15-percent limitation in a situation involving a loss based upon both fair market value and the employee's cost. In this case $500 of the reimbursed amount (the portion of the $5,000 reimbursement in excess of 15 percent of gross selling price) is not considered part of the amount realized on the sale.

Case C shows the fair market value limitation. Here, the old residence was sold for its value (which equaled its cost), but the employee was reimbursed $1,000 for a "loss" he did not incur. Under the provision, this $1,000 is not considered part of the amount realized on the sale.

(c)(ii) *Effective date.*—The amendment made by this provision shall apply to reimbursements received with respect to sales contracts entered into after December 31, 1960, in taxable years ending after such date.

(d) *Revenue effect.*—This amendment is expected to result in a revenue loss of $45 million in a full year of operation.

40. Dispositions of depreciable real estate (sec. 233 of the bill and sec. 1250 of the code)

(a) *Present law.*—Under present law, taxpayers may take depreciation on real property (other than land) used in a trade or business or held for the production of income. The depreciation methods available are the same as those applying to tangible personal property. They include (1) straight-line depreciation; (2) 150 percent declining balance depreciation; (3) double-declining balance depreciation; (4) sum-of-the-years-digits depreciation; and (5) any other consistent method of depreciation which does not during the first two-thirds of the useful life of the property result in greater depreciation than under the double-declining balance method. The 150-percent declining balance method is available with respect to used real property only under certain circumstances. The last three methods of depreciation referred to are available only for property with a useful life of 3 years or more and only if the property was new property in the hands of the taxpayer.

The depreciation is allowed as a deduction against ordinary income. As the depreciation deduction is taken the cost or other basis of the real property is reduced by a like amount. If the property subsequently is sold, any gain realized on the difference between the sales price (adjusted downward for selling expenses) and the adjusted basis of the property is taxed as a capital gain if the total transactions in depreciable property and certain other property (referred to in sec. 1231) result in a gain for the year involved. On the other hand, where the aggregate of these transactions results in a loss, the net loss is an ordinary loss.

(b) *General reasons for provisions.*—Since the depreciation deductions are taken against ordinary income while any gain on the sale of the property is treated as a capital gain, there is an opportunity under present law in effect to convert ordinary income into capital gain. This occurs whenever the depreciation deductions allowed reduce the basis of the property faster than the actual decline in its value.

Congress in the Revenue Act of 1962 recognized the existence of this same problem in the case of gains from the disposition of depreciable machinery and other personal property. In that act, the Congress provided that any gain realized on the sale of these assets in the future would be ordinary income to the extent of any depreciation deductions taken in 1962 and subsequent years with respect to the property.

In the case of real estate, this problem is magnified by the fact that real estate is usually acquired through debt financing and the depreciation deductions allowed relate not only to the taxpayer's equity investment but to the indebtedness as well. Since the depreciation deductions relate to the indebtedness as well as the equity in the property, this may permit the tax-free amortization of any mortgage on the property. As a result in such cases there is a tax-free cash return of a part of the investment which may in fact enable the taxpayer to show a loss for several years which he may offset against income for tax purposes.

In 1962, Congress did not include real property in the recapture provision applicable to depreciable personal property because it recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time. The bill this year takes this factor into account. It makes sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed the deduction which would have been allowable had the taxpayer limited his deductions to those available under the straight-line method of depreciation. Secondly, a provision has been added which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate. As a result, under the bill, no ordinary income will be realized on the sale of real estate held for more than 10 years.

(*c*) *General explanation of provisions.*—In view of the considerations set forth above, the House and your committee have amended present law to provide that when depreciable real estate is sold after December 31, 1963, in certain cases a proportion of any gain realized upon the sale of the property is to be treated as ordinary income; that is, previous depreciation deductions against ordinary income are to be "recaptured" from the capital gains category.

The bill accomplishes this result by treating as ordinary income a certain percentage of what is called "additional" depreciation or the amount of gain realized on the sale of the property, whichever is smaller.[1] Generally, the "additional" depreciation referred to here is that part of the depreciation deductions which exceeds the depreciation deductions allowable under the straight-line method. The depreciation deductions taken into account, however, are only those taken after December 31, 1963. Thus, they are the excess of any depreciation deductions taken under the double-declining balance method,

[1] This provision also applies to certain dispositions where there is not a sale or exchange. Therefore, the bill refers not only to the excess of the amount realized over the adjusted basis of the property but also, so that the provision will apply to these dispositions which are not sales or exchanges, it refers to the excess of the fair market value of the property over its adjusted basis.

sum-of-the-years-digits method, or other method of rapid depreciation, over the depreciation which would have been taken under the straight-line method. In the case of property held for 1 year or less, however, the deductions recaptured are to include not only the excess over straight-line depreciation, but rather the entire depreciation deductions taken.

The bill limits the depreciation recapture to the excess over straight line depreciation because it is believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains. Moreover, it is believed that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation deductions. For that reason, the bill also tapers off over a 10-year period the proportion of the additional depreciation (or gain where smaller) which is to be treated as ordinary income upon the sale of the property.

This is accomplished by providing that the additional depreciation (or gain if smaller) which otherwise would be treated as ordinary income is to be decreased by 1 percentage point for each full month the property is held in excess of 20 full months. Thus, the amount which will be treated as ordinary income in the case of property held for a full 21 months would be 99 percent (the applicable percentage) of the amount which otherwise would be so treated. This decreases 1 percent for each succeeding month the property is held until the applicable percentage decreases to zero for property held for 10 years or more.

The property which is to be given the type of treatment described above is depreciable real property other than real property which is eligible for the investment credit. Such property is already subject to the recapture rule provided by section 1245 which generally applies to tangible personal property. The types of real property, therefore, which are not subject to this provision are property other than buildings or structural components which are used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services or represent research or storage facilities used in connection with these activities. Examples of the types of real property which, therefore, are not included under this provision are railroad track and bridges and blast furnaces.

This provision applies only to the additional depreciation allowed or allowable. Consequently, the enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction for depreciation is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, is not intended to affect this holding.

(c)(i) *Substantial improvements.*—Because the percentage of additional depreciation (or gain, if smaller) decreases after the first 20

months by 1 percent a month, it is necessary to determine when property has been acquired. This presents a special problem where real estate already held is substantially improved. To consider the substantial improvement as being held for the same period as the original investment in the property would mean that where property has been held for 10 years or more there would be no ordinary income arising with respect to substantial improvements, even though these improvements might have been made within the last few years. To prevent avoidance of the ordinary income treatment provided by this provision, the bill defines a "separate improvement" which is treated as a separate element for purposes of determining the amount treated as ordinary income upon the sale or exchange of real property. Appreciation which may be treated as ordinary income is divided up among the separate elements in accordance with the additional depreciation deductions with respect to each element.[1]

A separate improvement is intended by the bill to be only an improvement which is of a substantial nature. Lesser improvements are treated as if they were a part of the original structure and do not take a new, or separate holding period for purposes of determining the proportion of the additional depreciation (or gain, if smaller) treated as ordinary income. As a result, separate improvements are defined under the bill as arising only where the cost of the improvements in question is greater than the largest of the following three amounts—

1. 25 percent of the adjusted basis of the property;
2. 10 percent of the original cost of the property plus the cost of any improvements made prior to those being considered here less the cost of retired components; or
3. $5,000.

These tests are applied over a 3-year period. Thus, if improvements made in any 3-year period increase the adjusted basis of the property before that period by 25 percent or more or exceed the amount specified under the other tests if larger, then this entire amount will be treated as a separate improvement. The 25-percent adjusted basis test in this case is expected to be the principal test applied; however, the 10-percent test will prevent a relatively moderate improvement in a fully, or almost fully, depreciated building from being classified as a substantial improvement. The $5,000 limitation is intended as a de minimis rule below which no aggregate amount in a 3-year period would be treated as a substantial improvement.

In applying the above test for determining whether an improvement is to be treated as substantial, improvements in any one of the 3 years are to be omitted entirely if they do not amount to at least $2,000, or 1 percent of the original cost of the property plus the cost of any improvements previously made (less the cost of retired components), whichever is the greater. As in the case of the $5,000 limitation, which applies over the 3-year period, these exceptions are designed as a de minimis rule to make it unnecessary to treat as separate improvements relatively minor improvements made in any one of the 3 years which may be involved in the computation in question.

In the future additional depreciation allowed over straight line depreciation is to be subject to recapture not only in the case of the

[1] In addition to the separate improvements, the bill also treats as separate elements units of real property which were placed in service at different times before initial completion of the building.

double-declining balance and other forms of rapid depreciation available only in the case of new property, but also the excess over straight line depreciation is to be recaptured in the case of depreciation, such as the 150-percent declining balance depreciation which presently is permitted with respect to used real property under certain circumstances.

(c)(ii) *Disposition where ordinary income is recognized.*—Ordinary income under the bill is recognized not only in the case of the sale or exchange of real property but also in the case of all other types of dispositions unless a specific exception is provided. Thus, as in the case of the provision enacted in 1962 in connection with tangible personal property, this provision may result in the recognition of ordinary income even though capital gain might not otherwise have been realized at the time of such a disposition. The bill provides seven general categories of exceptions, however, where dispositions are not to result in the recognition of any ordinary income.

The first exception is for gifts. Thus, the making of a gift for this purpose will not be a taxable event. However, the depreciation deductions of the donor in such a case are carried over to the donee. As a result, if the donee subsequently sells the real property, there may be ordinary income recognized by him as a result of depreciation deductions taken by the donor. The donee in such a case, however, will receive the benefit of the holding period of the donor. The effect, therefore, of this is to treat the donor and donee for purposes of this provision as if they were one person, with the result that upon the subsequent sale by the donee of the property, the same amount (if any) will be treated as ordinary income as if the donor held the property throughout the entire period. Similarly, in determining the percentage decrease in total gain to be taken into account as ordinary income, the holding period of both the donor and the donee is taken into account. This, of course, means that a smaller proportion of the gain will be treated as ordinary income than would be true if only the donee's holding period were used for this purpose.

In the case of real property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the bill provides that the amount of the charitable contribution deduction he may receive is reduced by the amount which would have been treated as ordinary income had the real property been sold at its fair market value (amendment to sec. 170(e)). This conforms with the treatment provided in 1962 by Congress with respect to tangible personal property contributed to a charity.

A second exception to the recognition of ordinary income upon the disposition of real property is provided in the case of transfers at death (except where the sale has occurred before death, in which case the amount is treated as income with respect to a decedent under sec. 691). In this case, however, there is no carryover of the income potential of the depreciation deductions to the decedent's devisee or heir.

A third category of exceptions to the recognition of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis of the real property is carried over from the former to the new owner. However, in these transactions where there is any gain recognized because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of

this gain, ordinary income may be recognized or to the extent of the applicable percentage of the additional depreciation deductions if smaller. The tax free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer of property by a corporation which is a party to a reorganization in pursuance of a plan of reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (secs. 371(a) and 374). Also included in the same category are contributions of real property to a partnership in exchange for an interest in the partnership, and distributions by a partnership of real property in partial or complete liquidation of an interest in the partnership (but in this respect, see the special partnership treatment described below). Under the bill, however, there will be a recognition of ordinary income where there is a contribution of depreciable property to a tax exempt organization (other than an exempt farm cooperative) in exchange for stocks or securities in the exempt organization. Recognition of gain in this case, as in the case of tangible personal property in the provision added last year, is provided because a disposition of the property by the exempt organization ordinarily would escape the realization of the ordinary income with respect to these deductions.

A fourth category of exceptions is provided in the case of so-called like-kind exchanges of real property used for production or investment and for involuntary conversions. In exchanges of these types, the ordinary income recognized is in general limited to any appreciation in value attributable to depreciable real property which is not reinvested, after the exchange or involuntary conversion into other depreciable real property. Thus, ordinary income will be recognized to the extent of the additional depreciation, decreased according to the holding period involved, or by the following amount of appreciation, whichever is the smaller. First, to the extent that the exchange or conversion results in actual gain being recognized, this will be treated as ordinary income under the general rule. Second, this gain will be increased by stock purchased in a corporation even though under the involuntary conversion provision this generally would not result in the recognition of gain. This amount is treated as potential ordinary income since any subsequent sale of the stock does not represent the sale of a depreciable asset and, therefore, it would not be possible in this event to recapture the depreciation. Third, to the extent of any remaining appreciation represented by real property, ordinary income is recognized to the extent this unrealized appreciation cannot be included in the basis of the newly acquired real property. Under this provision, the newly acquired real property will, upon its sale or other disposition, give rise to the same ordinary income, decreased according to the holding period for the newly acquired property, as would the previously held real property (except to the extent that ordinary income was recognized at the time of the conversion). The holding period for purposes of determining the percentage of the additional depreciation which is to be treated as ordinary income is begun anew with respect to the exchange or converted property, but the new holding period applies only to the percentage of the gain which would have been taken into account had the property held been sold at the time of the exchange or conversion.

A fifth exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases, also, the ordinary income includes not only the actual gain recognized but also the appropriate percentage of any depreciation charges unrecovered at the time of the sale or exchange which are not reinvested in other depreciable real property.

A sixth exception is provided in the case of distributions of real property by a partnership to a partner. A distribution of real property by a partnership to a partner, to the extent that the distribution represents the partner's share of unrealized appreciation attributable to this property, is not to result in ordinary income to the distributee partner at the time of the distribution. However, the unrealized appreciation representing additional depreciation taken by the partnership will be carried over to the distributee partner. When he disposes of this real property, the unrealized appreciation represented by these partnerships (or by an earlier transferee where the partnership acquired the property without recognizing gain), additional depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. This rule applies only to the extent a partner is considered as receiving his share of the real property to which is attributable potential ordinary income. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in real property is to be considered as "unrealized receivable." Thus, to the extent of applicable percentage of the additional depreciation deductions taken (or potential gain, if smaller) ordinary income will be recognized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of real property reflecting this ordinary income.

A seventh exception deals with the case where the property being disposed of by the taxpayer is his principal residence. Under present law (sec. 1034) where the taxpayer sells his principal residence and within a year before or after this sale (18 months after in the case of the construction of a new home) purchases or builds another, then any gain realized on the sale of the first residence is not recognized for tax purposes to the extent the total proceeds from the sale of the first residence are invested in the second. The bill provides that in cases of this type, to the extent the full proceeds from the sale of the first residence are reinvested into a second, no ordinary income is to be recognized at that time.

Similarly, the bill provides no recognition of ordinary income potential with respect to the provision incorporated elsewhere in this bill (sec. 206 of the bill) which provides that no gain is recognized by a taxpayer age 65 or over who sells a home which he has used as a personal residence and owned for 5 out of the last 8 years.

As in the case of the provision enacted in 1962 relating to tangible personal property, the House and your committee in this provision found it necessary to recognize ordinary income in cases where capital gain is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without

the payment of a tax at the corporate level on unrealized appreciation in value; namely, where the real property is distributed as a dividend (sec. 311), where the real property is distributed as part of a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the real property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the real property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholder in a liquidation under section 337 (12-month liquidation) results under this bill in the recognition of the same amount of ordinary income of the corporation as would have been realized on a cash sale of these notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the real property to the receiving shareholder is determined under section 334(b)(2) (purchase of 80 percent of the stock of one corporation by another corporation followed by immediate liquidation of the corporation acquiring). The other situations where ordinary income may be realized under this provision although capital gain would not otherwise occur, include the case where distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this real property. Other cases include the provision relating to the exchange of like-kind property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases where the property received in exchange for depreciable real property is not itself depreciable real property, then ordinary income is recognized.

(*c*)(*iii*) *Leasehold improvements.*—Improvements made to property held under a lease by a lessee present a special problem in determining what is the amortization period equivalent to the straight-line depreciation method selected as the norm in the usual case. Present law (sec. 178) in general provides that leasehold renewal periods are to be taken into account in determining amortization or depreciation with respect to any year if the initial lease period remaining is less than 60 percent of the useful life of the building or other improvement, or if less than 75 percent of the cost of the lease is attributable to the remaining portion of the initial lease period, and if it is more probable that the lease will be renewed, extended, or continued than that it will not. Such a test is appropriate when looking forward to amortization deductions in future years. However, it does not represent an adequate norm for the measurement of excess or additional depreciation after the deduction has been taken and the lease is being sold.

As a result, the bill provides that in determining the norm for purposes of specifying additional depreciation which may be treated as ordinary income, periods for which a lease may be renewed, extended, or continued under an option exercisable by the lessee are generally to be taken into account. However, the renewal periods so taken into account are not to extend the amortization period by more than two-thirds of the initial lease period remaining after the improvement was made. Thus, in the case of a 6-year lease with a 6-year renewal period, only 4 additional years are to be taken into account in determining the amortization period of an improvement made at the beginning of the initial lease. Thus, in this case, the amortization

payments with respect to the lease would be spread over a 10-year period and payments in excess of such a spreading would be considered additional depreciation adjustments. However, if the useful life of the asset itself in such a case were less than 10 years, then the depreciation deductions would be spread for this purpose in a straight-line method over the useful life of the asset, and this would be used as the measure in determining additional or excess depreciation adjustments.

(*c*)(*iv*) *Effective date.*—This provision is to apply with respect to depreciation attributable to periods after December 31, 1963, and to dispositions of property after that date.

(*d*) *Revenue effect.*—Since this provision relates only to depreciation deductions in 1964 and subsequent years, the initial revenue impact of this bill is expected to be small. In fiscal year 1965, it is expected that this provision will result in a revenue gain of about $5 million. In subsequent years, however, when the provision becomes fully effective, it is anticipated that it will result in a revenue gain of approximately $15 million a year.

41. Income averaging (sec. 234 of the bill and secs. 1301–1305 of the code)

(*a*) *Present law.*—Present law does not provide any generally available income averaging provision for the persons whose income fluctuates widely from year to year. Instead, present law contains six specific averaging provisions dealing with special types of situations: Certain compensation for personal services, income from inventions or artistic work, certain income from backpay, compensation for damages for patent infringements, breach of contract damages, and damages for injuries under the antitrust laws.

In the case of the provision relating to compensation for personal services and that relating to inventions and artistic works, in order to be eligible for this treatment, the employment involved must have covered 36 months or more in the case of the compensation for personal services, and in the case of the work on the inventions or the artistic works must have covered a period of 24 months or more. In addition, eligibility under these same two provisions required that the receipts of the payments involved with respect to the work be heavily concentrated in 1 year. In the case of compensation for personal services, 80 percent or more of the total compensation for the employment must have been received in the taxable year in question. In the case of the invention or artistic work, the amount received in the year in question must not be less than 80 percent of the gross amount received with respect to the invention or artistic work in the taxable year, all prior years, and the succeeding 12 months. The backpay provision also has a somewhat similar provision. To be eligible for averaging in the case of backpay, the amount of backpay received in the taxable year must exceed 15 percent of the gross income for that year.

In the case of all of the present averaging devices, the averaging is achieved by providing that the tax involved is not to be greater than if this income were spread back, either ratably over the period to which the income relates, or to the specific years to which the income relates. However, in the case of income from inventions, the spread back for this purpose may not exceed 60 months, and in the case of artistic work it may not exceed 36 months. The other averaging

provisions are not limited in this respect. The tax in each case, although imposed as of the current year, is determined by making a recomputation with respect to one or more back years.

(*b*) *General reasons for provisions.*—A general averaging provision is needed to accord those whose incomes fluctuate widely from year to year the same treatment accorded those with relatively stable incomes. Because the individual income tax rates are progressive, over a period of years those whose incomes vary widely from year to year pay substantially more in income taxes than others with a comparable amount of total income but spread evenly over the years involved. This occurs because the progressive rates take a much larger proportion of the income in taxes from those whose incomes in some years are relatively high. The absence of any general averaging device has worked particular hardships on professions or types of work where incomes tend to fluctuate. This is true, for example, in the case of authors, professional artists, actors, and athletes as well as farmers, fishermen, attorneys, architects, and others.

The present averaging provisions have proved unsatisfactory, first because they are limited to a relatively small proportion of the situations where averaging is needed. Thus, while they presumably cover inventors and writers, they do not provide for actors, athletes, and in most cases do not provide for attorneys, architects, and others. Even in the case of inventors and authors, the present provision is inadequate because of the requirement that the income arise over at least a 24-month period and 80 percent or more of the income from the invention or work be concentrated in the current year in question. In practice, many cases involving authors and inventors where averaging is needed do not meet these specific requirements. This was made clear in testimony from authors and others.

The present averaging provisions also have proved unduly complicated in practice because of the requirement that the prior years' incomes and taxes must be recomputed as if the income had actually been received in those prior years.

Your committee agrees with the House that income averaging should be designed to treat everyone as nearly equally for tax purposes as possible, without regard to how their income is spread over a period of years and without regard to the type of income involved. At the same time, it is necessary to have any income averaging device in a form which is workable, both from the standpoint of the taxpayer and the Internal Revenue Service.

Although the bill generally repeals the averaging devices in present law (secs. 1301–1307), it is recognized that cases may arise where a person has entered into long-term contingent employments upon the assumption that the averaging device in present law applicable to compensation from an employment would be available. Since employments in some cases may last for extended periods of time, such as 20 years, the general 5-year averaging device might produce less favorable treatment than the present provision. As a result, the bill provides, in the case of these long-term employments which were already in being before 1963, for the taxpayers involved to continue the form of averaging available under present law if they elect to forgo the general 5-year averaging provided in this bill.

(*c*) *General explanation of provisions.*—In view of the considerations set forth above, the bill deletes all of the averaging provisions in

present law referred to previously and substitutes instead an income averaging device available to individual taxpayers generally, substantially without regard to the source of the income. As indicated subsequently, however, in the case of the averaging device for compensation from an employment, the bill in certain cases permits the continuance of the application of this provision.

Under the averaging rule provided by the bill, once the amount of income to be averaged is determined—called averageable income in the bill—and assuming this amount is more than $3,000, the taxpayer is to compute a tentative tax on one-fifth of this amount. The tax on this one-fifth is determined by adding this one-fifth to 1⅓ times the average income received in the prior 4 years, plus the average capital gains income in this same 4-year period. The tax attributable to this one-fifth is then multiplied by 5 to determine the final tax on this income.

Averaging is available only where the "averageable income" exceeds $3,000 because, with the present progressive rate structure with tax brackets usually of $2,000 to $4,000, smaller amounts achieve little if any benefit from averaging. The device of including one-fifth of the averageable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this result by 5, achieves a result which is substantially similar (except when there are rate changes during the 5 years) to including one-fifth of the income eligible for averaging in the taxable income base of each of the prior 4 years and of the current year. The advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the 4 prior years in order to obtain this result.

The "averageable income" referred to here is the excess of the taxable income in the current or computation year—with certain adjustments—over 1⅓ times the average base period income. The average base period income is the average of the taxable income in the 4 prior years with certain adjustments specified below.

Averageable income is limited to that which is in excess of 1⅓ times average income in the base period for two basic reasons. First, in any new provision of this type, it is necessary to limit the number of cases to which the new provision will apply to a manageable level from the administrative standpoint. In other words, it was necessary initially, at least, to limit the volume of cases where averaging will be applied. Moreover, it is clear that the greatest need for averaging occurs where the fluctuation in income levels varies widely. An increase of more than one-third from the prior average income was selected to make the new averaging rule available in those cases where it is needed the most.

As indicated above, in computing the income subject to averaging, it is necessary to make some adjustments in both the income of the current, or computation year, and also in the income of the 4 base period years with which the current year's income is compared. The income of the computation year, referred to in the bill as the "adjusted taxable income" is the taxable income for that year decreased by: (1) Any capital gain net income for that year; (2) any income for that year attributable to gifts, bequests, devises, or inheritances received during that year or any of the four prior base period years;[1]

[1] Income attributable to gifts, bequests, devises, or inheritances between a husband and wife are not taken out of the income for the computation year if they file a joint return for the computation year or one of them makes a return in that year as a surviving spouse. Also not taken into account are amounts of less than $3,000 in computation year.

(3) any excess of wagering gains in the year over wagering losses; and (4) certain amounts of income to which penalties apply with respect to owner-employees who are self-insured for pension plan purposes (sec. 72(m)(5)).

Long-term capital gains are excluded from the income subject to averaging in the computation year on the grounds that such income does not require averaging because of the fact that only 50 percent of the capital gain income is included in the tax base in any event. Moreover, without regard to the averaging provision, such income is subject to a maximum rate of 25 percent.

Averageable income also excludes income from gifts, devises, or inheritances where the gifts, etc., have been received either in the computation year or in any of the four prior base period years, because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. In addition, in the case of the transfer by gift of income producing properties between related parties, there would be some opportunity for manipulation if such income were not excluded from that which can be averaged. Income attributable to such property is excluded under the bill only where it is in excess of $3,000 in the computation year. Also, because it may be difficult to trace specific income to specific gifts, bequests, devises, or inheritances, the bill presumes that such property earns a 6-percent rate of return unless the taxpayer establishes to the satisfaction of the Treasury that some other amount of income is earned with respect to the property.

Net wagering gains are excluded from averageable income to prevent such income from receiving a preferred status. For similar reasons, penalty income of owner-employees in the case of self-insured pension plans is excluded.

It is also necessary to make some adjustments in the base period income with which the adjusted taxable income for the computation year is compared. Two of these adjustments are the same as those made in the computation year. Thus, capital gain net income for the base period year is excluded as is any income from gifts, bequests, devises, or inheritances where such property was initially received by the taxpayer in 1 of the 4 base period years.

A third adjustment made to the average base period income is to add back to such income any income excluded from the taxpayer's base in such year on the grounds that it was earned in a foreign country (the exclusion under sec. 911 of present law) or on the grounds that it was income from sources within a possession of the United States (sec. 931 of present law). The inclusion of such amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging.

(c)(*i*) *Example.*—For most taxpayers with little or none of the income which gives rise to the special exceptions described above the application of this averaging provision is relatively simple. This can be illustrated by an example of an unmarried taxpayer having an average base period income of $3,000 in the years 1961–64 and an adjusted taxable income of $44,000 in 1965. The taxpayer in this

case is eligible for averaging since his "averageable income" exceeds $3,000. His averageable income in this case can be computed as follows:

1. Adjusted taxable income in computation year	$44, 000
2. 133⅓ percent of average base period income ($3,000× 133⅓ percent)	4, 000
3. Averageable income	40, 000

Since the averageable income is in excess of $3,000, the entire amount is subject to averaging.

Computation of tax:

(*a*) 133⅓ percent of average base income ($3,000× 133⅓ percent)	4, 000
(*b*) Averageable income included in tentative tax base (⅕ of $40,000)	8, 000
(*c*) Tentative taxable income	12, 000
(*d*) Total tentative tax liability (1965 rates under bill)	2, 830
(*e*) Tax on $4,000 not subject to averaging	690
(*f*) Tax liability on ⅕ of averageable income	2, 140
(*g*) Tax on total averageable income ($2,140× 5)	10, 700
(*h*) Total final tax liability (tax on $4,000 not subject to averaging and $40,000 subject to averaging)	11, 390
(*i*) Tax on $44,000 under 1965 rates without averaging	18, 990

(*c*)(*ii*) *Treatment of capital gains and priority of taxing different types of income.*—As previously indicated, net capital gains—any excess of net long-term gains over capital losses—are excluded from the adjusted taxable income for the computation year in determining how much of this income is to be eligible for averaging and also from the average base period income. Thus, generally, capital gains (other than short-term capital gains) have no effect in determining the income subject to averaging. There is one exception to this general rule, however. If the average capital gain net income in the base period exceeds the capital gain net income in the computation year, then to the extent of this excess the income subject to averaging is reduced. Generally, it was thought that capital gains should be set apart and not taken into account in averaging since they, in effect, have their own specialized form of averaging. However, in those cases where the average capital gains in the base period exceed the capital gains in the computation year, it is believed that averaging should be permitted only when total taxable income of the current year is substantially greater than the average of the base period.

The bill provides that in determining the tax which is attributable to the income subject to averaging, the first income subject to tax is to be the ordinary income not eligible for averaging. In the example previously presented, this meant that the $4,000 of income not subject to averaging was considered to be the income subject to the first income brackets. The income subject to the next higher income rates is the capital gain net income of the computation year but only to the extent [1] this does not exceed the average base period capital gain net income. Following this is the income subject to averaging, with respect to which one-fifth is included, the tax then computed, and the result multiplied by 5. Any remaining capital gains income in the computation year, in excess of average base period capital gain net income, is treated as coming on top of this income subject to averaging along with income from wagering or gifts, bequests, devises, or inheritances, which is not eligible for the averaging treatment.[2]

[1] Actually this amount is preceded by an amount equal to any excess of average base period capital gain over capital gains of the computation year in those infrequent cases where such income exists.

[2] The penalty income with respect to owner-managers in connection with receipt of pension-type income is treated as if the averaging provision did not apply.

The alternative capital gains tax in such a case is determined by applying 25 percent to the long-term capital gains. This tax then is compared with the tax attributable to the capital gains in the computation explained above. The reason for structuring the tax base in the manner indicated is to give assurance that the income subject to averaging is taxed, as nearly as possible, at the same income level as would be the case had such income been earned ratably over the current year and 4 prior years.

(c)(iii) *Eligible individuals.*—To be eligible for averaging, one of the principal concerns is that the individual's income must have been subject to tax by the United States throughout the entire base period as well as the computation year. No one is eligible for averaging who was a nonresident alien in any of the 4 base period years or in the computation year. To be eligible for averaging, the individual must be a citizen or resident in the computation year. In addition, even though a citizen in the computation year, the individual must be claiming no exclusion in that year for income earned abroad. He may have claimed such an exclusion with respect to a base period year, but, for purposes of determining his income in the computation year subject to averaging, this income is added back to his base period income.

A second concern of this provision is that the individual be a member of the labor force in both the computation year and in the 4 base period years. It has been necessary, however, to approximate this result in some cases. The general rule provides that the individual and his spouse must have furnished one-half or more of his own support in each of the base period years. However, it was not intended to exclude from the benefits of the averaging provision an individual who, although in the labor force, was unemployed in part or all of the base period years. For that reason, individuals generally are eligible for averaging if they are 25 years old and there have been at least 4 years since the individual attained age 21 when he was not a full-time student. Thus, generally, individuals age 25 or over will be eligible for averaging so long as they have been out of school for at least 4 years since age 21. A second exception is provided for the individual who, although not self-supporting in the 4-year base period, nevertheless, has income in the current year more than half of which is attributable in substantial part to work he has done in two or more of the base period years. This is designed to make sure that those who have performed some work of a substantial nature which occurred over a period of years will be eligible for averaging even though below the 25-year age limit. A third exception is provided for an individual who was not self-supporting in the base period and who makes a joint return with someone else if not more than 25 percent of the total adjusted gross income of the couple in the computation year is attributable to the individual in question. This means that an individual who has been in the labor force and who marries someone who was a dependent of another will not be deprived of averaging, assuming three-quarters or more of the income in the computation year is attributable to the individual who was in the labor force in the base period. This is designed to assure that a man who marries a woman who was a dependent of her father during part or all of the base period years is not deprived of income averaging as a result of this marriage.

(*c*)(*iv*) *Special rule with respect to marital status.*—No problems arise in applying the averaging provision where a husband and wife file a joint return in the computation year and also did so in each of the base period years. However, it is necessary to reconstruct their income where they either filed separately (or with other spouses) in the base period years or are filing separately in the computation year. For example, if a married couple files a joint return in the current year but filed separate returns for one or more base period years, their base period income for purposes of averaging in the current year will be their combined base period incomes for their base period years. In addition, the bill provides that an individual's base period income is to be either his actual base period income in each of the base period years or, if higher, 50 percent of the combined base period income of him and his spouse.[1] In determining actual income for purposes of this provision, community property laws are not to be taken into account with reference to income from personal services. Thus, the actual income attributed to an individual will be the income earned by him without regard to whose income it is considered to be under community property law.

(*c*)(*v*) *Continuance of present averaging device in certain cases.*—The bill provides that the averaging device in present law with respect to compensation from an employment is to continue to be available if the taxpayer so elects where he receives or accrues compensation from employment which began before February 6, 1963. If the taxpayer elects this treatment he must forgo for that year the generally available averaging device and the carryover of certain excess charitable contributions.

This provision, which on this elective basis is continued for compensation for the employment begun before the specified date, provides in general that the employment must cover a period of 36 months or more and that the gross compensation from the employment received by the individual (or partnership) in the year in question must not be less than 80 percent of the total compensation for such employment. Where these conditions are met, present law provides that the tax is not to be greater than if the compensation had been included in the gross income of the individual ratably over the period of the employment prior to the date of the receipt or accrual.

(*c*)(*vi*) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This means that averaging will be available for the first time with respect to taxable years beginning in 1964. This will involve base period years as far back as 1960. However, as indicated previously, the averaging device in present law relating to compensation from employment where the employment began prior to February 6, 1963, may continue to be applicable for taxable years beginning after December 31, 1963, at the election of the taxpayer.

(*d*) *Revenue effect.*—This provision is expected to result in a reduction of $40 million of tax liabilities in the calendar year 1964 and subsequent years.

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[1] If the individual involved was married to another person in one or more of the base period years, his base period income is to be not less than 50 percent of his income in that year combined with the income of whichever spouse had the higher income.

42. Small business corporations: Ownership of certain stock disregarded (sec. 235(a) of the bill and sec. 1371 of the code)

(*a*) *Present law.*—In 1958 Congress added to the Internal Revenue Code a new subchapter (sec. 1371 and following) which provides that the earnings of certain small business corporations may be taxed to the shareholders of the corporation (rather than taxing the corporate entity as such) in a manner somewhat similar to the way partnership earnings are taxed to the partners rather than to the partnership. Where the tax treatment provided by this subchapter is elected, the shareholders include in their own income for tax purposes the current taxable income of the corporation, both the dividends which have been distributed and the portion of the earnings which are still retained by the corporation. This treatment was provided in order to permit businesses to select the form of business organization desired without the necessity of taking into account major differences in tax consequences.

The right to elect the treatment provided under the new subchapter was limited to small business corporations in part because of the complexity involved in passing the earnings of a corporation through to its shareholders where the stock of the corporation is held by a widely diversified group of shareholders, and in part because it was thought that only the relatively small corporations were essentially comparable to the partnership or proprietorship where the earnings are taxed to the owners rather than to the business organization. As a result, Congress provided that corporations making this election must be domestic corporations which are not eligible to file a consolidated return with any other corporation. Also, they must have not more than 10 shareholders, their shareholders must all be individuals (or estates), no nonresident aliens may be shareholders, and the corporations may not have more than one class of stock.

(*b*) *General reasons for provision.*—Situations have been called to your committee's attention where corporations are denied the privilege of electing to have their income taxed to their shareholders (rather than to the corporation) merely on the grounds that the corporation owns the stock of completely inactive subsidiaries.

The establishment of inactive subsidiaries is a common business practice for corporations planning for future growth. Such corporations often desire to reserve their corporate name in States in which they are not yet doing business by establishing subsidiaries with the same or a similar name to that of the parent corporation. Your committee sees no reason to penalize the parent corporation by denying it the privilege of electing to pass the income through to its shareholders for tax purposes merely because, for business reasons, it has established these inactive subsidiaries which constitute an affiliated group which could file a consolidated return.

(*c*) *General explanation of provision.*—As a result of the considerations set forth above, this provision adds a new subsection to section 1371 of the code providing that a corporation will not be considered a member of an affiliated group for purposes of this election (and, therefore, not be denied the right to elect subch. S status) merely because it owns stock in another corporation which is inactive. An inactive corporation, in this case, is one that has not begun business after the date of its incorporation and before the end of the parent corporation's taxable year in question and that does not have taxable

income for this taxable year. If these conditions are met and the parent is not affiliated with any other corporation, an election may be filed under subchapter S by the parent corporation despite the rule that a subchapter S corporation may not be a member of an affiliated group. However, if the subsidiary corporation does not meet the conditions set forth above in a subsequent year, the parent corporation's subchapter S status would be terminated at that time.

(*c*)(*i*) *Effective date.*—This bill is effective for taxable years of corporations beginning after December 31, 1962.

(*d*) *Revenue effect.*—It is estimated that this provision will result in a negligible loss of revenue.

43. Small business corporations: Certain distributions of money after close of taxable year (sec. 235(b) of the bill and sec. 1375 of the code)

(*a*) *Present law.*—As indicated above, the earnings of small business corporations may be taxed to the shareholders of the corporation in a manner somewhat similar to the way partnership earnings are taxed to the partners rather than to the partnership. The shareholders are taxed each year on the dividend income received from the corporation plus any additional earnings of the corporation which are retained by it rather than distributed. If in a particular year such a corporation does not in fact distribute its earnings, any distributions in a later year are treated as dividend distributions to the extent of the earnings and profits of that later year. In addition, if in that later year the corporation has ceased being an "electing small business corporation" then all distributions are treated as being dividends to the full extent of both current and accumulated earnings and profits.

(*b*) *General reasons for provision.*—The rule stated above has created a problem where an electing small business corporation sells a capital (or depreciable) asset, adopts a resolution to distribute to its shareholders all or part of the proceeds of such sale, and then actually does distribute such proceeds in the year immediately following the year of sale. In such a case, even though the shareholders pay tax on the full capital gains in the year of the sale, the distribution to them in the later year will be treated as an ordinary dividend at least to the extent of the current earnings and profits of the later year. The result will be even harsher if in the later year the corporation has ceased being an electing small business corporation, because in this case the distribution will be a dividend to the extent of both the current and the accumulated earnings of the corporation.

(*c*) *General explanation of provision.*—To prevent the result described above, your committee's bill adds a provision to the effect that in the case of an electing small business corporation a distribution of money to the shareholders on or before the 15th day of the third month following the close of a taxable year, may, at the election of the corporation, be treated as a distribution of money made on the last day of the taxable year in question. This election is available whether or not the corporation involved is an electing small business corporation in the second year.

(*c*)(*i*) *Effective date.*—This amendment applies to taxable years beginning after December 31, 1957.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a negligible loss of revenue.

44. Repeal of additional 2-percent tax for corporations filing consolidated returns (sec. 236 of the bill and sec. 1503 of the code)

(*a*) *Present law.*—Under present law a consolidated income tax return may be filed by a group of parent and subsidiary corporations where there is 80 percent control of each level of the chain of corporations, and there is a common parent corporation; 80 percent control, in this case, means 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock. In the consolidated return, intercompany transactions are washed out, and it is possible to offset losses of one corporation against the gains of other members of the group. These intercompany transactions which are washed out also include intercompany dividends. As a result, dividends may be paid from one company in a consolidated group to another of the same group without the second member including in its income 15 percent of this dividend income.

Under present law, where the election to file a consolidated return is made, a special tax is levied equal to 2 percent of the consolidated taxable income of the group.

(*b*) *General reasons for provision.*—The bill removes the special 2-percent penalty tax on the privilege of filing a consolidated return, in part because the return of commonly controlled corporations as a single economic unit for tax purposes is in accord with the reality of the situation. Moreover, there appears to be no reason why, where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere presence of more than one corporate organization in the group should result in any penalty tax. No such penalty, for example, is exacted in the case of other corporate organizations operating through divisions rather than separate corporations.

In addition, the removal of this 2-percent penalty tax should encourage the filing of consolidated returns and serve as a brake on the expansion of the use of multiple surtax exemptions to gain tax advantages.

(*c*) *General explanation of provision.*—In view of the considerations set forth above, both the House and your committee's version of the bill repeals the special 2-percent tax on consolidated returns, effective with respect to taxable years beginning after December 31, 1963. This 2-percent tax presently applies to the consolidated taxable income of the affiliated group of includible corporations.

(*d*) *Revenue effect.*—The repeal of the 2-percent tax on consolidated corporate returns is expected to decrease revenues by $50 million a year.

45. Reduction of surtax exemption in case of certain controlled corporations (sec. 237 of the bill and secs. 1561–1563 of the code)

(*a*) *Present law.*—Under present law, corporations are taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on all income over that amount. This tax rate differential results from the fact that the first $25,000 of income of a corporation is subject to the 30-percent normal tax but is exempt from the 22-percent surtax, while income in excess of $25,000 is subject to both the 30-percent normal tax and the 22-percent surtax. This tax structure was intended to encourage small businesses which operate in corporate form. However, medium and large enterprises have in some cases taken advantage of the lower rates afforded small business by organizing their corporate structure in multiple corporate form.

As a result, the Internal Revenue Code contains several provisions designed to prevent taxpayers from using the multiple form of corporate organization, to avoid taxes. For example, present law provides (sec. 269) that where an individual or corporation acquires control of a corporation and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, this deduction, credit, or allowance is not to be allowed. Also, elsewhere (sec. 1551) present law provides that if a corporation transfers part or all of its property (other than money) to another corporation created to acquire the property, or not actively engaged in business at the time of the transfer, and if there is common control of the two corporations, then the transferee corporation is not to be allowed the $25,000 surtax exemption or the $100,000 accumulated earnings credit unless it establishes by the clear preponderance of the evidence that the securing of the exemption or credit is not a major purpose of the transfer. In addition, present law (sec. 482) provides that where two or more corporations are owned or controlled directly or indirectly by the same interest, the Secretary of the Treasury or his delegate may allocate deductions, credits, or allowances between or among these corporations, if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations.

(*b*) *General reasons for provision.*—This bill reduces the tax applicable to the first $25,000 of taxable income from 30 to 22 percent and decreases the tax applicable to income above $25,000 from 52 to 50 percent in 1964 and to 48 percent in subsequent years. One of the effects of this change is to increase the value of a surtax exemption from $5,500 (22 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation under present law to $6,500 (26 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation for 1965 and subsequent years.

While the importance to small business of reducing the tax on the first $25,000 of income from 30 to 22 percent is recognized, it is believed that this substantial tax reduction should not provide added inducement to existing medium and large corporations to split up into multiple corporations. Therefore, the bill limits the benefits of the tax reduction in cases where a parent corporation owns or controls one or more other corporations, or where a single individual, trust, or estate owns or controls two or more corporations.

By limiting the benefits of the tax rate reductions in the case of groups of multiple corporations, it is possible to grant a substantial tax reduction to small business in reducing the normal tax rate to 22 percent, as was recommended by the President, without granting the same benefits to medium and large enterprises which use, or might choose to use, the multiple corporate form of organization. The method of taxing controlled corporations contained in the bill will, in the opinion of the House and your committee, when coupled with repeal of the 2-percent additional tax on consolidated returns, encourage some controlled groups to file consolidated returns, while leaving groups which do not choose to file consolidated returns in approximately the same relative position they are in under present law.

While the House and your committee recognize the advantages of use of multiple corporations, it is believed, as it has been in the past,

that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, the House and your committee do not intend to encourage the formation of these multiple corporations and therefore propose to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes.

(c) *General explanation of provision.*—If a controlled group exists, three basic alternatives are available to corporations which are members of the group:

(1) The corporations in the group may forego the use of multiple surtax exemptions, i.e., they each file separate income tax returns and allocate one $25,000 surtax exemption among the members of the group (and either elect or not elect the 100-percent dividends received deduction provided by sec. 215 of this bill).

(2) Corporations in the group may elect to pay a penalty tax and file a multiple surtax exemption return. Under this election each member of the group (subject to the tax avoidance provision) may claim a separate $25,000 surtax exemption, but each must also agree to pay an additional tax of 6 percent on the first $25,000 of its taxable income. With the generally applicable rates of 22 percent on the first $25,000 of taxable income and 50 percent or 48 percent on income over $25,000, this means a total tax for such companies of 28 percent on the first $25,000 of income and 50 percent in 1964 and 48 percent in 1965 and subsequent years on income over $25,000.

(3) A controlled group which also qualifies as an "affiliated group" of corporations may, as under present law, file a consolidated income tax return.

This third alternative is similar to the first alternative in that only one $25,000 surtax exemption is available to the corporations filing the consolidated return. However, there are additional benefits in filing a consolidated return arising from the ability to declare and receive dividends between members of the group without tax, and to offset losses of one company against another.

The bill does not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of foregoing multiple surtax exemptions and the definition of a group eligible to file a consolidated return. Several differences arise. However, many complicated problems are involved in equating the two, and many avoidance possibilities might be created if they were equated. Thus, for example, a foreign corporation doing business in the United States is included in the controlled group definition. However, if the foreign corporation is also doing business abroad and was permitted to join in a consolidated return, it could pass a dividend, out of its foreign earnings, tax free to the domestic parent, and thus escape all U.S. taxes. Moreover, neither the House nor your committee is aware of any situations in which the discrepancies in the two

definitions would create a hardship (especially with the 100 percent dividends received deduction provided by this bill). If it develops, however, that the differing definitions create a substantial hardship for certain groups subject to the penalty tax which cannot file consolidated returns (or obtain a 100-percent deduction for dividends received), the decision would have to be reconsidered and adjustments made to the extent possible.

(*c*)(*i*) *Test of control.*—In determining whether a controlled group of corporations exists, the bill draws a distinction between a parent-subsidiary controlled group and a brother-sister controlled group. In a parent-subsidiary controlled group one corporation, called a parent corporation, owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of one or more corporations called subsidiary corporations. The parent-subsidiary controlled group also includes corporations below the first tier subsidiary level which are 80-percent owned by the other corporations in the group. For example, if corporation A owns 80-percent of the stock of corporation B, and corporation B owns 80 percent of the stock of corporation C, corporations A, B, and C constitute a parent-subsidiary controlled group.

A brother-sister controlled group exists where a single individual, trust, or estate owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of each of two or more corporations.

In determining whether a corporation, or a single individual, trust, or estate, owns 80 percent of the value or voting power of the stock of a corporation, the stock of the corporation is considered not to include nonvoting preferred stock, which more closely approximates a debt obligation than an equity interest, and treasury stock, which, from the standpoint of ownership, constitutes unissued stock. Moreover, certain outstanding stock, although owned by separate persons, could, unless neutralized for purposes of determining control, be used by some owners as a means of divesting themselves of sufficient stock to avoid the application of this section without, as a practical matter, divesting themselves of the benefits of ownership of a corporation. Therefore, in determining whether a parent-subsidiary controlled group exists, stock of a subsidiary corporation owned by (1) individuals who are 5-percent shareholders of the parent corporation, (2) officers of the parent corporation, (3) employees of the subsidiary if the stock is subject to restrictions which favor the parent or subsidiary corporation, and (4) trusts which are part of a plan of deferred compensation for the benefit of the employees of the parent or subsidiary corporation, will not be treated as outstanding stock if the parent corporation owns 50 percent or more of the value or voting power of the stock of the subsidiary. In addition, in determining whether a brother-sister controlled group exists, stock of a corporation owned by (1) a trust forming a part of a stock bonus, pension, or profit-sharing plan for the benefit of the employees of the corporation, and (2) employees of the corporation if the stock is subject to conditions which run in favor of such corporation or the common owner and which substantially restrict or limit the employee's right to dispose of stock will not be treated as outstanding stock if the individual, estate, or trust owns

50 percent or more of the value or voting power of the stock of the corporation.

In determining whether a single individual, trust, or estate owns 80 percent of the value or voting power of the stock of a corporation, such individual, trust, or estate is, in addition to the stock owned directly, considered to own stock by virtue of certain relatively limited attribution rules. The first rule provides that an individual is considered to own stock owned by his spouse. However, it is recognized that in many cases a husband and wife may each own and operate their separate businesses. In order to prevent attribution in such cases, which may have the effect of denying separate surtax exemptions to each corporation, an individual is not considered to own stock owned by or for his spouse if (1) the individual does not directly own stock in the corporation in which his spouse owns stock, (2) the individual is not a director or employee of such corporation and does not take part in the management of such corporation, (3) not more than 50 percent of the gross income of the corporation is derived from rents, royalties, dividends, interest, and annuities, and (4) the stock of the corporation owned by the spouse is not at any time during the taxable year subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock if such right runs in favor of the individual or his children who have not attained age 21 years.

The bill also provides limited attribution rules in cases involving other family relationships. Thus, an individual is always considered to own the stock owned by his children who have not attained age 21. However, an individual is considered to own the stock owned by his children who have attained age 21 and grandchildren only if such individual owns, directly or indirectly, more than 50 percent of the value or voting power of the stock in the corporation. Similarly, children who have not attained age 21 are considered to own the stock held by their parents, but children who have attained age 21 and grandchildren are considered to own the stock held by their parents or grandparents, respectively, only if the child or grandchild owns, directly or indirectly, more than 50 percent of the stock of the corporation. There is no attribution between brothers and sisters. Limited attribution rules are also provided in cases involving stock held by trusts, estates, and partnerships. Stock owned by a corporation, directly or indirectly, is considered to be owned proportionately by any shareholder owning a 5-percent or greater interest in the corporation. If an individual, estate, trust, or corporation owns an option to buy stock in a corporation, for purposes of ascertaining a controlled group, such "person" is deemed to own the stock covered by the option.

(c)(ii) *Method for determining existence of a controlled group of corporations.*—Determination of whether a controlled group of corporations exists is made once each year on December 31 by taking into account the stockownership of each person who owns stock in the corporation for the taxable year including such December 31. Although the determination of the corporations included within a parent-subsidiary controlled group, or a brother-sister controlled group, is made without regard to the type of corporation involved, provision is made to limit the reduction in the surtax exemption (or payment of the additional tax) to those corporations, referred to in the bill as component members, whose income tax is determined in whole or in part by reference to the normal and surtax rates. Thus, exempt organizations which do

not have unrelated business income, and foreign corporations which are subject to a flat rate tax on their income from sources within the United States, are not considered to be component members.

In order to limit reduction of surtax exemptions (or payment of the additional tax) to cases in which the common owner of the controlled group would otherwise derive the principal benefit from the allowance of the exemption, the bill excepts from the definition of component member those corporations which are members of the controlled group for less than one-half of the days in their taxable year which precede the applicable December 31 determination date.

In addition to corporations which meet the ownership tests described above on the applicable December 31 determination date, the term "component member" also includes a corporation whose stock is not owned by the parent corporation or common owner on such December 31 but was so owned one-half or more of the number of days in the corporation's taxable year which includes the applicable December 31. The inclusion of such "additional members" as component members prevents corporations whose stock is sold before the end of the year from obtaining the benefits of an extra surtax exemption in the year in which they leave the controlled group.

The bill also provides for cases where certain manufacturing corporations, in an effort to facilitate the retail distribution of products which they produce, enter into agreements with individuals whereby the manufacturer and the individual each contribute capital to a distributing corporation under a plan by which a portion of the compensation of the individual from the distributing corporation is applied toward the retirement of the stock held by the manufacturer. In most cases, franchised corporations of this type are, by definition, excluded from a controlled group due to the fact that the manufacturer owns less than 80 percent of the value and voting power of the stock of the distributing corporation. However, in some cases the corporate structures of these corporations are arranged in a manner which results in the parent corporation, or common owner, owning more than 80 percent of the vote, but not more than 80 percent of the value, of the stock of the distributing corporation.

Your committee agrees with the House that it would serve no useful purpose to cause these corporations to reorganize their corporate structures and has, therefore, excluded them from the definition of the term "component member" of a controlled group.

Finally, due to the nature of the business conducted by life insurance companies, and the fact that a life insurance company is not permitted to file a consolidated return other than with another life insurance company, a life insurance company is excluded from the definition of a "component member" of a controlled group unless the controlled group contains two or more life insurance companies, in which case the life insurance corporations are treated as component members with respect to each other since they may then elect to file a consolidated return with each other. A mutual insurance company, other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 821, which is included in a controlled group is also excluded from the definition of a "component member."

(c)(*iii*) *Privilege of groups to elect multiple surtax exemptions.*—The bill provides that the component members of a controlled group of

corporations may elect to have each component member of the controlled group claim a separate surtax exemption in lieu of having one surtax exemption apportioned among such members. However, if the component members of a controlled group so elect, the income tax on each member is increased by 6 percent on so much of its taxable income which does not exceed $25,000. For example, assume individual A is a common owner of a brother-sister controlled group of corporations consisting of corporations X and Y. Further assume that corporations X and Y each have taxable income of $35,000 and that they elect to have each member claim a separate surtax exemption and pay the additional 6 percent. By taking separate surtax exemptions, each corporation would pay a total tax of $7,000 on the first $25,000 of income (28 percent, consisting of a 22-percent normal tax and a 6-percent additional tax), and a tax of $4,800 on the remaining $10,000 of income (48 percent, consisting of a 22-percent normal tax and a 26-percent surtax), for a total tax on each corporation of $11,800. On the $70,000 combined income of the controlled group this would be a tax of $23,600. Alternatively, if the group did not make the election, the total tax on the controlled group would be $27,100 (22 percent of the first $25,000 of income and 48 percent on the remaining $45,000 of income). Under these circumstances, corporations X and Y presumably would choose separate surtax exemptions with the penalty tax, rather than apportioning a single surtax exemption between the component members of the controlled group.

For the component members of a controlled group to elect to claim multiple surtax exemptions, all component members of the group must join in the election. Such an election must be made within 3 years after the date when the income tax return is required to be filed for the taxable year of the component member of the controlled group whose taxable year ends first on or after the December 31 for which the election applies. An election once made may be terminated by the consent of the members, by the refusal of a new member of the controlled group to consent, by the filing of a consolidated return by any component members of the group, or by the termination of the group. Once an election is terminated, the bill provides that the group may not again elect multiple surtax exemptions until the expiration of 5 years. In the case of reorganizations involving groups of corporations some of which, for example, are, and some of which are not, prevented from filing new elections under the 5-year period, the Secretary of the Treasury is required to issue regulations which provide which group is to be treated as the predominant (or successor group) and hence which group's characteristics are to carry over.

(c)(iv) Disallowance of surtax exemption and accumulated earnings credit.—The bill makes two basic changes to present section 1551. The first change provides that if a corporation transfers property (other than money) directly *or indirectly* to a corporation which it controls, and such transferee corporation was created for the purpose of acquiring such property, or was not actively engaged in business at the time of such acquisition, the Secretary of the Treasury or his delegate may disallow the $25,000 exemption from surtax, or the $100,000 accumulated earnings credit, unless the transferee corporation establishes by the clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose of the

transfer. As presently interpreted, existing law applies only to direct transfers of property other than money. The bill does not affect the transfer of money to a new corporation if the money is not used to indirectly acquire property from the shareholder making the transfer. Therefore, the amendment does not in any way inhibit the organization of new corporations with money transfers even though the corporation is organized for the purpose of acquiring a surtax exemption or accumulated earnings credit. However, the new corporation may be a component member of a controlled group in which case a single surtax exemption is allocated among the members of the group unless the group elects to file a multiple surtax exemption return.

The second change from present law extends the application of section 1551 to transfers of property (other than money) by an individual to a corporation which he and not more than four other individuals control. For purposes of determining whether the transferor is considered to be in control of the transferee corporation, the individual who makes the transfer, together with no more than four other individuals, must own at least 80 percent of the value or voting power of the stock in two or more corporations, one of which is the transferee corporation, and the same individuals must own more than 50 percent of the value or voting power of the stock in each corporation (only taking into account identical stock holdings) after the transfer. In determining ownership of stock, the constructive ownership rules for determining if a controlled group exists are applicable.

(*c*)(*v*) *Effective date.*—The amendment with respect to the limitation of the number of surtax exemptions allowable to component members of a controlled group and authority for component members to elect to file multiple surtax exemption returns is effective with respect to taxable years of corporations ending after December 31, 1963. The amendment made to section 1551 is effective with respect to transfers made after June 12, 1963.

(*d*) *Revenue effect.*—It is expected that this provision will increase revenues by about $35 million in a full year of operation.

46. Validity of tax liens against mortgagees, pledgees, and purchasers of motor vehicles (sec. 238 of the bill and secs. 6323(c) and 6324 of the code)

(*a*) *Present law.*—An assessed tax—income, estate or gift, excise, or withheld income or social security tax—if not paid within 10 days after notice and demand, constitutes a lien upon all of the property of the taxpayer, both real and personal. This lien follows the taxpayer's possessions, but it is valid as against a purchaser, mortgagee, or judgment creditor only if the notice of the tax lien has been filed prior to the sale or mortgage in the place designated by the State for the filing of such notices—usually the county recorder's office.

(*b*) *General reasons for provision.*—A prospective purchaser or mortgage lender with respect to real estate will check with the county recording office to ascertain whether there are any outstanding liens on the property. Ordinarily, liens against automobiles and trucks are not recorded in the county recorder's office. In many States any lien upon the automobile or truck is stated on the title. The one who wants to record a chattel mortgage, for example, upon an automobile must present his chattel mortgage and the certificate of title to the motor vehicle department of the State. Dealers in used automobiles,

therefore, rely upon these title certificates to determine whether or not there is any adverse lien on the automobile which they intend to purchase. However, the certificate of title does not show any Government tax lien. Thus, a dealer having unknowingly bought a car from a delinquent taxpayer may find that the car is seized by the Internal Revenue Service to satisfy the lien.

An automobile or truck dealer buying hundreds of used cars or trucks each year finds it difficult to follow the normal procedures—search of the records in the county recording office—with respect to each car which he wishes to buy. A similar situation exists with respect to the sale of stocks and bonds, which are ordinarily sold on the stock exchanges or over the counter without knowledge of any Federal tax lien which might exist with respect to such securities. For this reason, the law has long provided in the case of securities (sec. 6323(c)) that even though the Federal tax lien has been filed in the appropriate recorder's office, the lien will not be effective as against any mortgagee, pledgee, or purchaser of a security if at the time of the mortgage, pledge, or purchase the mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien. Your committee believes that a similar procedure with respect to autos and trucks would be appropriate.

(*c*) *General explanation of provision.*—This section of your committee's bill provides a similar protection for dealers and other persons purchasing or making loans upon motor vehicles as is now provided in the case of securities, so that the lien of the Federal Government will not be effective against a purchaser, mortgage lender or pledgee unless the purchaser, mortgage lender or pledgee has actual notice or knowledge of the existence of the Government's lien.

The definition of the motor vehicle to which this provision will apply is a vehicle (except a house trailer) registered for highway use under the laws of any State or foreign country.

(*c*)(*i*) *Effective date.*—The amendments made by this section apply only with respect to mortgages, pledges, and purchases made after the date of enactment of this bill.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue.

C. HOUSE PROVISIONS DELETED BY YOUR COMMITTEE

1. Reimbursement of medical expenses in excess of such expenses (sec. 204 of the House bill)

(*a*) *Present law.*—Present law provides that gross income is not to include amounts received through accident or health insurance for medical expenses for personal injuries or sickness (secs. 104(a)(3) and 105(b) of the code).[1] At the same time medical expense deductions may be claimed (if they exceed the 3-percent floor) for accident or health insurance premium payments.

(*b*) *Reasons for deleting the House provision.*—Cases were called to the attention of the House Committee on Ways and Means where individuals have been covered by more than one accident or health insurance program. This occurs on occasion when the individual himself carries more than one policy, and occurs in other cases when

[1] An exception to this rule provides that amounts received under accident or health insurance policies are to be included in gross income to the extent they represent medical expense deductions allowed in previous years.

the individual may carry a policy and also his employer may provide for the payment of medical care either through an insurance policy or through self-insurance. In these cases, the employee may receive double payments with respect to the same expenses incurred with respect to a given injury or sickness. In these cases, the House provision would have treated the excess of the amounts received over the actual expenses incurred as income received by the individual.

Your committee is in agreement with the objective of the House provision. However, it has been called to the attention of your committee that the National Association of Insurance Commissioners this last December adopted a report on overinsurance recommending the enactment of legislation at the State level pertaining to this subject. The legislation recommended in effect would provide amendments to the uniform individual accident and sickness policy provisions of State law providing that health insurance benefits are to be prorated in the event of overinsurance among the carriers on the risk. This recommendation of NAIC is likely to lead to changes in State law within the next year or two in many, if not most, of the States. This in effect would eliminate the overinsurance with which the House-bill provision is concerned. In view of this, your committee concluded that it would be better to remove the House provision from the bill and see if the problem of overinsurance is not met in the relatively near future by action by the various States. Your committee will review this matter within the next year or two and should implementing legislation not be acted upon by most of the States, it will then reconsider this provision. Your committee has concluded, however, that the problem is broader than merely the tax aspect and, therefore, that it would be more appropriately handled by the States than by amendment to the Internal Revenue Code.

2. Carrying charges (sec. 215(c) of the House bill)

(*a*) *Present law.*—Among the itemized deductions allowed taxpayers under present law is the deduction for interest payments. Administrative practice has long allowed as an interest deduction the portion of any carrying charges on installment purchases to the extent the interest element is stated separately. In 1954, Congress also provided that an interest deduction was to be available in the case of carrying charges stated separately even where the interest charged could not be ascertained directly. In such cases, the law provides that so much of the carrying charges as equal a 6-percent interest charge on the average unpaid balance under the contract is to be allowable as an interest deduction. This provision applies, however, only in the case of "personal property" purchased under an installment contract.

(*b*) *Reasons for deleting the House provision.*—Cases were called to the attention of the House Committee on Ways and Means where carrying charges are imposed with respect to tuition payments to various educational institutions. On the basis of this, the House bill would have extended the deduction for part of the carrying charge as interest in the case of carrying charges for services as well as personal property. Your committee would have no objection to extending this provision to cover service charges which are in the form of tuition payments; however, before this is extended to service charges, generally, your committee believes that there should be a further investigation of what might be covered under such a provision.

3. *Increase in basis with respect to certain foreign personal holding company holdings (sec. 216(j) of the House bill)*

(*a*) *Present law.*—Under present law the undistributed income of a foreign personal holding company is included in the income of the U.S. shareholders of the company and taxed to them. This treatment applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals who are citizens or residents of the United States. In addition, in the first year, 60 percent, and in subsequent years 50 percent, of the corporation's gross income must be "foreign personal holding company income." In general terms, this income consists of passive or investment forms of income, such as dividends, interest, etc. To a substantial degree, the same type of income is classified as foreign personal holding company income as is classified as personal holding company income in the case of domestic companies.

Stock in a foreign personal holding company differs from most other property in that, at the time of the death of the U.S. shareholder, it generally does not receive a new basis equal to its fair market value. Actually, the applicable rule in this case is that the basis of the stock at the time of the death of the decedent is to be the fair market value at that time or the basis of the stock in the hands of the decedent, whichever is lower.

For foreign corporations, including foreign personal holding companies, to participate in a tax-free reorganization it must be determined to the satisfaction of the Secretary of the Treasury that the exchange was not in the pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Of the two basic tax provisions on corporate liquidations, sections 331 and 333, foreign companies can use only section 331. Section 331 provides for the imposition of the regular capital gains tax on appreciation in the value of the stock. Section 333, which foreign corporations cannot use, provides that the accumulated earnings and profits of the corporation are to be taxed to the noncorporate shareholders as dividends and that capital gains are to be recognized on other appreciation in the stock only to the extent of the money and stock or securities acquired by the corporation after December 31, 1953, exceed the earnings and profits received as dividends. However, this provision also provides, in the case of assets acquired by the corporation before January 1, 1954, that no gain is to be recognized to the shareholder but that instead the shareholder is to receive the same basis for the assets received which he had for the stock (increased for gain recognized and decreased for money received).

(*b*) *Reasons for deleting the House provision.*—The House Committee on Ways and Means noted that the stock of a foreign personal holding company, when the shareholder dies, received much harsher treatment than is true of practically all other property included in the decedent's estate. Generally, property receives a new basis at a decedent's death equal to its fair market value, either at the time of the decedent's death or at the alternate valuation date 1 year later. Moreover, in the case of gifts where the donee carries over the basis of the donor, an increase in the basis (up to fair market value) is allowed to the donee with respect to any gift taxes paid on the property.

The House recognized that a relatively harsher treatment for the basis of the stock of these foreign personal holding companies is justified in order to discourage their use generally. However it was believed that it was appropriate to permit the same general type of adjustment to the basis as is presently permitted in the case of gifts; namely, to permit an increase in the basis of the stock of the foreign personal holding company equal to the death transfer tax imposed with respect to the appreciation in the value of the stock.

In view of the fact that the issue of a carryover of basis at date of death has not been dealt with by your committee in this bill, it concluded that it would be more appropriate to postpone consideration of this amendment until that broader topic was under consideration.

In addition, the House bill provided that these foreign personal holding companies were to be treated the same as domestic corporations for purposes of section 333 if the liquidation is completed shortly after the date of enactment of this bill. Since such companies are likely to have little if any accumulated earnings and profits, this in effect means that the shareholders would pay a capital gains tax on the appreciation of their stock in the corporation only to the extent they receive money, or stock or securities acquired after December 31, 1953, and that the basis of assets received in the liquidation is the basis of their stock in the corporation increased by the gain recognized. In such cases this property was to receive the same basis as it would if the shareholder died still holding the stock in the foreign personal holding company until this property had passed through one estate—the shareholder's or any transferee's.

Your committee has also decided not to include this aspect of the House provision in your committee's amendments. The same issue of the basis at date of death is involved here as where the stockholder dies still holding the stock of such a company.

4. Capital gains and losses (*sec. 219 of the House bill*)

(*a*) *Present law.*—Under present law, capital gains and losses are divided into two general classifications: short-term capital gains and losses and long-term capital gains and losses. The former are gains and losses on assets held for not more than 6 months and the latter are gains or losses on assets held for longer periods of time.

Gains and losses in each category are first offset against other gains or losses in the same category. Thus, there is determined "net," short-term gains or losses and "net" long-term gains or losses. Next, any net short-term gains are offset by net long-term losses or vice versa.

Net short-term gains in excess of net long-term losses are taxed to individuals or to corporations as ordinary income. In the case of net long-term gains in excess of net short-term losses, however, the tax treatment applicable to individuals and corporations differs somewhat. In the case of individuals, such a gain is included in the taxpayer's ordinary income and then reduced by a 50-percent deduction, or alternatively, the entire gain is omitted from the taxpayer's ordinary income base and a flat 25-percent tax paid with respect to this gain. In the case of corporations, there is no special 50-percent deduction. Instead, the corporation either includes the entire gain in its ordinary income, or alternatively, pays a tax of 25 percent on these capital gains.

The tax treatment of capital losses also differs somewhat between individuals and corporations. As previously indicated, any net short-term loss is first offset against any net long-term capital gain and vice versa. If there still remains an excess of capital losses (either short term or long term), these losses may be offset against ordinary income in the case of individuals but only to the extent of $1,000. If any net loss still remains, it may be carried forward for a period of up to 5 years as a short-term capital loss (whether such loss was in reality a long- or short-term loss) and as such in each of the years in succession first offset against net short-term capital gains, then against net long-term capital gains and finally against ordinary income to the extent of $1,000.

In the case of corporations, capital losses as in the case of individuals are first offset against gains in their own category (short term or long term) and then against gains in the other category. However, any remaining loss may not be offset against ordinary income to any extent, but it may be carried forward as a short-term loss and offset against short-term and long-term capital gains in each of the 5 succeeding taxable years.

The capital gain and loss treatment described above applies in the case of the sale or exchange of capital assets. In addition, certain other items are taxed in the same manner as capital gains. The principal category of assets treated in this manner are depreciable assets. Such assets, if the gains exceed the losses, are treated as capital gains; but, if the losses are in excess of the gains, they are treated as ordinary losses. Included with depreciable property for this purpose also are gains or losses from—

1. the sale of timber;
2. coal royalties;
3. livestock held by the taxpayer for draft, breeding, or dairy purposes if held by him for 12 months or more;
4. the sale of an unharvested crop sold in connection with the sale of the land.

Other types of items which are eligible for capital gain treatment are patent royalties received by the creator of the patent, certain lump-sum pension payments, and certain termination payments received by employees with more than 20 years employment. Income arising from the sale of stock acquired under a restricted stock option represents still another form of income accorded capital gains treatment under present law. In addition, this bill (sec. 228) provides capital gain treatment for iron ore royalties.

(*b*) *Reasons for deleting the House provision.*—The House bill would make three basic changes in the tax treatment of capital gains and losses. First, it would decrease from 50 to 40 percent, in the case of individuals, the proportion of the capital gain included in the tax base where the asset involved has been held for more than 2 years, and it would provide in such a case a maximum tax rate of 21 percent in lieu of the 25 percent; second, it would limit the more favorable capital gains treatment described above so that this treatment would not be made available with respect to transactions where the capital gains treatment under present law is made applicable to certain types of assets which are not capital assets; and, third, it would provide an indefinite carryover of unused losses in the case of individuals in lieu of the present 5-year limitation.

The Secretary of the Treasury in his testimony before your committee requested that the first two of the changes listed above not be made. He based this primarily on the fact that the administration in recommending lower capital gains tax rates had done so only as a part of a recommendation providing additional taxation on unrealized gains at death. Subsequently, this recommendation was modified to call for a carryover of the decedent's basis in such a case to the one receiving the property from the decedent. The House Committee on Ways and Means considered this latter proposal but rejected it at least in part on the grounds that there were technical problems which had not been satisfactorily worked out. In view of this, the Secretary of the Treasury in his testimony before your committee strongly urged that it not consider reducing the capital gains tax rates at this time.

In addition to the question raised by the Secretary of the Treasury as to whether capital gains tax rates should be lowered at the present time in view of the fact that other related structural changes are not now being made, questions arise as to the desirability of dividing the long-term capital gains group into two parts. Information submitted to your committee made it quite clear that this would substantially further complicate an already complex capital gains tax schedule. If the House provision had been adopted, not only would it be necessary to report separately three instead of two general categories of capital gains, but it would also be necessary to subdivide the proposed class A and class B gains between those coming under section 1231 and those which do not. Although gains from the sale of such assets result in capital gains where there is a gain from all such assets taken together, nevertheless, if there is a loss from the aggregate of these transactions with respect to these assets, they give rise to ordinary gain or loss. In addition, it is necessary on this schedule to account for the "recapture" of ordinary income provided generally for tangible personal property in the Revenue Act of 1962 and the somewhat different "recapture" rule provided in this bill with respect to real estate. As a result of the interrelationship of these factors, your committee concluded that it would be better not to further complicate this schedule at the present time by this further breakdown of what are presently long-term capital gains or losses for individuals.

Your committee also was concerned about the capital gains provision of the House bill because the benefit from this provision would have been largely concentrated in the very highest income brackets. The concentration of capital gains in the higher income levels in fact is a major factor accounting for the effective rates in the highest brackets being substantially below the rates shown in the tax rate schedule. Table 11 shows, for example, that, although those with incomes over $200,000 represent a small fraction of 1 percent of all the taxpayers, nevertheless they receive 16 percent of all capital gains. This is about the same percentage of capital gains received by the 58 percent of all taxpayers having incomes below $5,000. Those with incomes of $100,000 or over, although representing only 0.04 of 1 percent of all taxpayers, nevertheless receive 24 percent of all capital gains.

The effect of reducing the capital gains inclusion factor, or alternative rate, because of this concentration of these gains in the higher income classes would, of necessity, have meant that most of this relief would have gone to those with the highest income levels. This

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is shown in table 12, which presents the overall distributional effects of the House and your committee's bill in detail for incomes over $50,000. This table indicates that, although the capital gains reduction in the House bill as a percentage of the present total tax amounted to only 0.7 of 1 percent, nevertheless the tax reduction which this would have accorded those with incomes between $100,000 and $200,000 would have been 3.4 percent; and this percentage would have risen to 7.4 percent for those with incomes of $1 million or over. This can be compared with the capital gains tax reduction accorded those with incomes of $3,000 and under of 0.3 of 1 percent. Your committee did not believe that a reduction of this type was justified in view of the overall distribution of reductions in this bill.

TABLE 11.—*Capital gains, by income levels*

Returns with adjusted gross income of—	Comprise this percentage of all taxpayers—	But receive this percentage of all capital gains
$200,000 and over	0.0096 of 1 percent	16
$100,000 and over	0.04 of 1 percent	24
$50,000 and over	0.2 of 1 percent	35
$10,000 and over	8.7 percent	69
Less than $5,000	57.8 percent	17

Source: Treasury Department.

TABLE 12.—*Overall distributional effects of the House bill (including capital gains changes) and the Finance Committee bill (which retains present law capital gains treatment)*

Adjusted gross income class (in thousands of dollars)	Total tax reduction as percentage of present tax		Capital gains tax reduction in House bill as percentage of total present tax
	House bill	Finance Committee bill	
0 to 3	38.6	38.6	0.3
3 to 5	26.5	27.3	.3
5 to 10	20.1	20.9	.2
10 to 20	16.9	17.3	.4
20 to 50	16.0	15.8	1.0
50 to 100	13.5	12.3	2.0
100 to 200	12.2	9.7	3.4
200 to 500	12.4	8.1	5.0
500 to 1,000	12.1	5.7	7.2
1,000 and over	12.0	5.6	7.4
Total	18.9	19.1	.7

Source: Treasury Department.

It should be noted that the great bulk of capital gains is accounted for by taxpayers by including 50 percent of the gain in income rather than by subjecting these gains to a separate flat 25 percent tax. It has been estimated that most of the capital gains fall in the former category where 50 percent is included in the ordinary income tax base. As a result, the regular rate reductions provided in this bill, which range from 30 percent for those in the bottom brackets to 23 percent for those at the top, will also be applicable in the case of these capital gains. Thus, even without any special tax treatment for capital gains, a substantial reduction in tax is provided by your committee's bill with respect to these gains.

INDIVIDUAL VIEWS OF SENATOR PAUL H. DOUGLAS

Good Features of the Bill

There are many good features in the present tax bill, H.R. 8363. Among these are (1) the fact of tax reduction itself which will stimulate demand, production, and employment; (2) the minimum standard deduction of $300 per taxpayer plus $100 for each family dependent (this with the per capita exemption of $600 means that families of four whose yearly incomes are less than $3,000 will be exempted from taxation—as they should be—instead of those under $2,666 as is now the case, i.e., $2,400 plus the 10 percent standard deduction); (3) the shifting of the corporation tax collection period from the present delayed system to roughly the same basis as taxes are now collected from individuals; (4) the repeal of the 4 percent dividend credit against taxes actually owed, and certain other features as well; and (5) the elimination by the Finance Committee of the reduction in the capital gains tax.

The capital gains loophole is already the largest loophole in our tax system. Between $5 and $6 billion a year are lost because of this provision. The bill as it came from the House of Representatives would have widened and deepened this hugh loophole by reducing the rate on long-term capital gains from 50 to 40 percent, subject to a maximum of 21 percent instead of the present inadequate rate of 25 percent. This was eliminated by a narrow margin in the committee. There is grave danger that this reduction will be restored in the conference committee. This danger will be reduced if the Senate itself, by a decisive vote, approves the action of the Finance Committee in eliminating this section from the House bill. This, in my judgment, should occur early in the Senate proceedings.

There are some grave defects in the bill as presented which I believe the Senate should correct. The bill also fails to effect much needed reforms in our tax system which are long overdue and for which there will not be another opportunity for some years.

Generally speaking, our present tax structure is riddled with injustices and inequities. There are so many loopholes that 20 people with incomes over $500,000 in 1959 paid absolutely no taxes at all while the average amount of taxes actually paid by all those with incomes of $5 million or more came to slightly less than 25 percent instead of the 90 percent they would theoretically be expected to pay. This is less than the amount which a typical American family with a taxable income of $12,000 derived from wages and salaries would be expected to pay or, because of collection at the source, would actually pay.

If we could close the various loopholes and "truckholes" in the Revenue Act, we could reduce the individual income tax rate from the present scale of 20 to 91 percent to a range of from 10 percent as the

minimum to a maximum of 50 percent. In doing so we would raise as much revenue as we do with our apparently high rates which, as a matter of fact, are not paid by the vast majority of those in the upper income tax brackets. In this connection it is appropriate to quote a salient passage from Philip M. Stern's forthcoming book entitled "The Great Treasury Raid" in which that keen student of our tax system, comments as follows:

> For a raid of its magnitude, the time (high noon) and setting (the U.S. Treasury, a stone's throw from the White House) showed a breathtaking boldness of design and planning. From out of nowhere, it seemed, they appeared—old people and young, rich and poor, an oil millionaire here, a factory worker there, a real estate tycoon, a working mother, several well-known movie stars, some corporation presidents, even the chairman of a powerful congressional committee. It was a mixed lot, all right, that converged on the Treasury Building that high noon. Into the building they strolled, gloriously nonchalant. No one stopped them; not a guard looked up to question them. Quickly and quietly they found their way to the vaults; opened them noiselessly with the special passkeys each had brought with him. Like clockwork, with split-second timing, each went to his appointed spot, picked up a bag and walked out as calmly as he had entered. At the exits the guards sat motionless. At precisely 12:04 it was all over. Each of the "visitors" had vanished into thin air.
>
> So had $40 billion from the U.S. Treasury.

The administration initially made a partial but somewhat ineffectual effort at tax reform. But when most of its proposals were rejected by the House Ways and Means Committee, they ceased to fight with any vigor except on two matters, namely (*a*) the abolition of the unjust 4 percent dividend credit inserted under the Eisenhower administration in 1954, and (*b*) the removal of the reduction in the capital gains tax. Neither of these features is in the present bill, and I hope we can hold these gains.

In other words, the great mass of citizens, primarily in the lower income brackets, have to pay high taxes because the laws have been so shaped that a minority are able, by avoidance and evasion and counseled by highly paid and able tax attorneys, to take advantage of every twisting and turning of the laws. I repeat, if we could plug the loopholes and "truckholes," we could collect the same total amount of revenue with half of the present tax rates. Our failure to do so means that the present unfair and unjust system continues. As a consequence, the present bill, except for the unjustifiable provision with respect to utilities, remains neutral with respect to remedying the great injustices in the tax system. Its failures are not, for the most part, acts of commission, but rather acts of omission. Because of the stimulus which the tax cut itself should bring to the economy, there are many like myself who can therefore support the bill because its stimulating features are good, but in the meantime express dissatisfaction over the failure of the House and the Senate committees to remedy many of the well-known and major loopholes in

the tax system. To us, tax reform is as important as tax reduction. But this bill has a great deal of reduction but very little reform.

The major loopholes in the system are (1) the present provisions for capital gains—the biggest loophole of them all. Huge amounts of ordinary income are taxed at a special lower rate, and other gains are not taxed at all, as in the case of the failure to tax capital gains at death.

The abuses involved in the oil depletion allowance, the writeoff of intangible drilling and development costs in the first year, and the ability of the oil industry to count royalties abroad as a tax payment instead of a deduction of expenses, is another area of grave abuse.

There are additional areas such as the unlimited charitable deduction, which is responsible for people with millions of dollars of income escaping any Federal taxation at all, and such other well-known loopholes as stock options, collapsible corporations, and corporate spinoffs, which mean that the favored few pay a smaller proportion of their income in taxes than the many with modest incomes.

Furthermore, State and local systems of taxation are highly regressive. That is to say, those with low incomes pay a higher proportion of their incomes in taxes than do those with high incomes. The progressive features of the Federal system should offset this so that the overall tax system of the country—Federal, State, and local—is at least proportional. But the fact that the Federal system is riddled with loopholes which favor high income groups, plus the fact that about $13 billion a year is collected in excise or sales taxes at the Federal level, means that even the Federal system has very little, if any, progression in it, and the total tax system is probably somewhat regressive in nature. The present bill fails to correct this situation. The repeal of some of the most onerous and least justifiable of the excise taxes could help to make our tax system more fair.

I therefore hope that we may take the following action to improve this bill:

First. We should try to get the Senate, by an overwhelming vote, to uphold the Finance Committee's action in knocking out the new capital gains loophole. This would strengthen the Senate's position in the conference committee. Otherwise, the capital gains provision in the tax law may end up worse than under present law. This should be a minimum position and it would certainly help if the Senate would also try to do something in the area of capital gains at death.

Second. The Senate should eliminate that feature of the tax bill which has no rightful place in a tax bill, namely, section 202(e) which states that the Federal regulatory commissions need not pass through the tax savings from the investment credit to the consumer. Apart from its lack of merit, this is basically a regulatory rather than a tax matter and really has no place in this bill.

Third. We should retain in the law the Long amendment of 1962 with respect to the investment credit. Corporations which invest $100 in investment reduce their taxes by $7. This is the equivalent of a $14 before-tax deduction. The Long amendment in 1962 said that a corporation could not depreciate more than $93 worth of investment, but the bill before us will allow the full depreciation of the asset even though its actual cost was less because of the investment credit. The elimination of the Long amendment will ultimately cost about $600

million a year and hence raise the investment credit to about 11 percent.

Fourth. The present provisions in the law with respect to stock options should be greatly modified and the provision in the bill with respect to the amount of term insurance which a corporation can purchase for its employees should be reduced at least to the House figure.

Fifth. We should try to repeal some of the retail excise taxes, such as those on leather goods, women's handbags, inexpensive jewelry, cosmetics, and furs, but we should place a limit of $100 on the amount which is free of tax so that we do not reduce the tax on luxury expenditures.

Sixth. Furthermore, we should certainly try to do much more than is done in the bill with respect to the oil depletion allowance. As a minimum, we should prohibit excess depletion from being used to offset income from sources other than direct oil production. This was proposed by Senator Williams in the committee, accepted twice, but finally considerably watered down at the last moment.

We should also consider an amendment to the depletion allowance which, while retaining depletion for the small producer who does take considerable risks, reduces the depletion allowance for those whose income from gas and oil is between $1 and $5 million to 21 percent, and for those with incomes from gas and oil in excess of $5 million to 15 percent. This would save $400 million a year.

Seventh. We should also not undo the minor progress made with respect to travel and entertainment allowance loopholes in 1962. We should not finally adopt some of the provisions either in the bill or which have been proposed to the bill.

Eighth and finally. We should consider the equity of the rate structure itself. The present bill grants about $2½ billion in tax reductions to corporations and over $9 billion to individuals. The latter is done by reducing the rates; namely, from the present 20 to 91 percent to a figure of 14 to 70 percent.

In addition, the bill splits the rates for the first bracket and gives a new minimum standard deduction. These last two features redeem the inequities in the nature of the personal tax reduction so that there is some degree of equity. However, there is neither a strong case nor any equity considerations involved in reducing corporate taxes by $2½ billion. Since 1954, corporations have had tax reductions of almost $5 billion through the 1954 fast tax writeoff and depreciation provisions, and the 1962 investment credit, and revision of Bulletin F. This bill grants another $2½ billion to corporations while individuals receive some reduction for the first time.

Because of this, it would be well to use some of the corporate reduction to increase the minimum standard deduction or to increase the $600 exemption. Personally, I would propose taking at least $1 billion from the corporate reduction and using the funds to increase the personal income tax reduction. This would be more equitable, would make the tax system more just, and, in my judgment, would give a much stronger stimulus to the economy than the present method.

Moreover, the Senate and the Congress should give serious consideration to simplifying the tax structure and making it more equitable

by the simple process of repealing most of the existing loopholes and truckholes in the tax laws and then using the gain in revenue to bring a drastic reduction in income tax rates. By closing most of the present loopholes, the tax rates could be reduced from the present level of 20 to 91 percent to a new level of about half that amount, or from 10 to 50 percent. This would simplify the tax structure, make it more just and equitable, and improve its enforcement, while benefiting the great mass of Americans who pay their taxes and who do not either avoid or evade them. The longer we put off tax reforms the more unjust our system becomes. The time to act is now.

PAUL H. DOUGLAS.

INDIVIDUAL VIEWS OF SENATOR RIBICOFF

This tax bill will have my vote, but not my unqualified approval.

Many unwise provisions have been included, some desirable provisions have been omitted, and the bill as a whole will not achieve all of the results that have been claimed for it.

Rate reduction and reform are the principal needs to which this bill should be directed. It achieves rate reduction. It does not achieve reform.

Unfortunately, the public has been largely unaware that the issues in this bill included anything more than simple rate reduction. To judge from the general reaction to the bill, one would think it contained a single provision saying, "Taxes shall be reduced by $11 billion." The fact is the bill containes more than 300 pages of detailed provisions, making a great number of changes in 37 separate areas of the Internal Revenue Code, in addition to the provisions making reductions in tax rates. In a few instances, these so-called structural changes do make modest reforms. But many needed reforms have not been made, and many of the changes in the bill are the opposite of reform: they are special preferences for a few taxpayers.

I do not agree that we should benefit—

utility companies by prohibiting the "flowthrough" of the investment credit to consumers;

department stores by allowing special tax treatment of revolving credit sales;

iron ore companies by providing capital gain treatment for certain royalty payments;

companies with foreign subsidiaries by permitting a 10-year carryforward for expropriation losses;

insurance companies by giving them capital gain treatment of bond discounts in certain situations; and

purchasers of new equipment by doubling the benefit of the investment credit.

These provisions are all included in the bill. The revenue loss for 1964 is estimated at $305 million.

Left out of the bill are provisions to reduce depletion allowances, end the immediate writeoff of intangible drilling and development costs for oil and gas, and abolish the preferential treatment of stock options. These provisions would have prevented a revenue loss in 1964 of $1,150 million.

These sums of money would more than pay for two other provisions which I believe should be included in this bill. These provisions would benefit the national interest and help millions of individuals. I will offer them as amendments on the Senate floor.

My principal amendment provides an income tax credit for college costs. The amendment provides a credit based on the first $1,500 of tuition, fees, books, and supplies at an institution of higher education. The credit is available to anyone who pays these costs—parents, students, or any other person who wants to pay for the

education of a deserving boy or girl. The credit is 75 percent of the first $200, 25 percent of the next $300, and 10 percent of the next $1,000. The credit is reduced by 1 percent of the amount by which the taxpayer's adjusted gross income exceeds $25,000—in other words, reduced $50 for each $5,000 of income above $25,000.

The financial burdens of high college costs are just as entitled to be eased through tax relief as medical expenses and casualty losses. These college costs hit middle income and lower middle income families with a serious impact. The man earning $8,000, $10,000, or $15,000 is generally not eligible for scholarship or loan funds for his son or daughter, and he faces a heavy burden in paying $2,000, $1,000, or even $500 for college costs.

One of the premises of this bill is that incentives should be given to capital investment. Yet there is no better form of capital investment we can make than investment in education. The investment credit in the 1962 tax bill and the revised depreciation guidelines provide over $2 billion in tax relief for investment in machinery. The pending bill provides millions more for this purpose. I believe we should invest in the education of our youth. In the last analysis, trained minds, not just new machines, will insure the success of this Nation.

Four main objections have been raised against this proposal:

1. It is claimed the amendment helps the wealthy. The fact is the credit benefits the $30,000 man less than the $5,000 man, and does not benefit the $60,000 man at all. Under this amendment, 91 percent of the dollar benefit goes to families with incomes below $20,000, 63 percent to families with incomes below $10,000.

2. It is claimed the amendment discriminates against the poor. The fact is the credit operates exactly like all other tax relief provisions of the Internal Revenue Code: it is available only to those who pay a tax. The medical deduction is not used by nontaxpayers, yet few would oppose it on this ground.

Those in the very low income groups who pay no taxes need a sound program of student aid including scholarships. I am for such a program. It is needed in addition to tax relief for the middle-income families. These are not alterntives. They are both necessities.

3. It is claimed the amendment favors the high tuition colleges, most of which are private colleges. The fact is the amendment favors the low tuition colleges, most of which are public colleges. The credit on a $200 expense is $150. That's 75 percent. The credit on a $1,000 expense is $275. That's only 27 percent. Even where a college charges no tuition, the expense of fees, books, and supplies invariably totals $200 or more.

4. It is claimed all the tax benefit will be absorbed in tuition increases. The fact is that tuitions go up whether tax relief is granted or not. Furthermore, any colleges that want to raise tuition because they know parents have some extra money will take advantage of the rate reductions in this bill. They can absorb the tax dollars that come from rate reductions, whether or not my amendment is added to the bill. Finally, the amendment provides only a 10-percent credit on expenses over $500, so every added $100 of tuition over $500 results in only a $10 saving to the parent—scarcely an incentive to the college.

For years proposals similar to this one have regularly been introduced by many Members of the Senate. I believe there should be an

opportunity for every Senator to vote on this proposal. I intend to see that this opportunity is provided.

My second amendment permits accelerated deductions of expenses for air and water pollution control equipment. If we are ever to make substantial progress in combating air and water pollution, we must recognize that private industry has a major part to play. But playing that part costs money. Since these expenditures are for a public purpose, the public should assume part of the burden through tax relief.

Industry needs financial encouragement to speed the acquisition of this equipment. This equipment produces no revenue to the company that installs it. Yet the Internal Revenue Code and many new amendments provided in this bill provide billions in tax relief for expenditures that are revenue producing. In fact, the Treasury Department last year proposed that fast tax writeoffs be provided for all equipment purchased for research and development expenditures which are clearly revenue producing.

When we are providing hundreds of millions to establish air and water pollution control programs, we should not overlook the need to help industry make the purchases of pollution control equipment which can make the difference between success or failure in cleaning up our environment.

Finally, I must express a word of caution concerning the claims that have been made for this bill as a whole. It can legitimately be called a needed stimulant to an economy that is not operating at full capacity. But it cannot and should not be expected, in and of itself, to spur that economy to full capacity or to solve many of the difficult problems that have been preventing our economy from reaching full capacity. Chief among these is unemployment and while this bill will help create new jobs, I do not believe it will solve the basic problem of structural unemployment. Economists with views as divergent as Leon Keyserling and Roger Freeman agreed on this point in testimony before the committee.

"I doubt that tax reduction can make a major impact on our present type of unemployment," said Freeman. "Even well-designed tax reduction cannot cope with a large portion of the unemployment problem," said Keyserling.

This joint warning should be well heeded. As we enact this tax cut bill, let us not delude ourselves or the country into thinking that it is a cure-all for our problems, especially for our unemployment problem.

We should pass this bill despite its imperfections. Taxes are too high and do act as a deterrent to individual initiative. This bill will be of benefit to all segments of our society and will be helpful to the economy. But we must continually strive toward the goals that remain: tax reform, a meaningful reduction in unemployment, and a fully productive economy.

Abraham Ribicoff.

MINORITY VIEWS OF SENATOR ALBERT GORE

Position in Brief

On balance, in the light of its design and consequences, and in view of its scope and magnitude, this is one of the most important and most ill-advised bills ever to come before the Congress for serious consideration.

Born of ineptitude in economic forecasting, sired by political considerations, and nurtured by the greed of special interests, it creates more inequity in many respects and bears no resemblance to true tax reform. Favoritism in tax law, furthered by H.R. 8363, threatens to erode our economic, political, and social structure.

Specifically, this bill—

(1) Is the embodiment of fiscal folly. While it is generally recognized, and I am no exception, that a balnced budget is not necessary or even desirable in every year, and in all circumstances, debt and deficit cannot be ignored indefinitely. After 3 years of unprecedented prosperity, expansion, and growth, and with nearly all the important economic indicators pointing upward, we certainly should not seek deliberately further to increase debt and deficit and to impair, for all foreseeable time our capacity to meet pressing public problems by a drastic reduction of governmental revenue.

(2) Provides no solution to our economic or social problems. The vast, unfulfilled economic needs of our society lie in the public sector—better housing for low-income groups, better mass transit systems, better educational facilities at all levels, better highways, more and better hospitals and nursing homes, more clean drinking and industrial water. The private sector of our economy is the wellspring of our continued prosperity, but this sector is fat with unused productive capacity. The unemployed and those burdened by poverty need specialized assistance in overcoming specific problems. Those who are so enamored of aggregates and macroeconomics fail to recognize that specific solutions are needed for very specific and pointed problems. The war on poverty is thus far but a skirmish of words—we need a pitched battle, with live and heavy ammunition, aimed at specific targets. Necessary programs require more, not less, revenue.

(3) Would provide the wrong type of tax cut, even if a large reduction in revenues were justified at this time. The tax reduction provided by this bill for the already very rich, through both a drastic reduction in high bracket personal income rates and a cut in corporate rates is unconscionable. Equity aside, sound economic theory is violated. If any shortage exists in our economy in the private sector, it is to be found in an absence of broadly based purchasing power. An equitable solution by way of revenue reduction would dictate a tax cut which would restore some of the prewar purchasing power which has, ever since that

time, been withheld. An increase in the personal exemption, with possible consideration being given to the restoration of some preferential treatment for earned income would be not only more equitable but more defensible from a purely economic standpoint. The reconcentration of wealth directly attributable to the tax cuts as well as indirectly realized from increased interest payments—acting as transfer payments—which will be stepped up by virtue of the built-in deficits created or increased by this bill, poses grave dangers. Political democracy can hardly survive without economic democracy.

Rate Reduction

general

The subject bill represents one of the most flagrant, obvious, and dangerous attacks of the past 35 years on the ideals, purposes, and underlying machinery of our economic democracy. Economic democracy is one of the hallmarks of our society, without which political democracy, social progress, and national purpose would soon cease to be.

In the name of equity this frontal attack is being made on the graduated income tax. The result will be a reconcentration of income and wealth in the 1929 pattern—an increased inequity.

In the name of economic expansion and employment opportunities, this bill would increase the already high liquidity of corporations, resulting not in increased jobs, but in increased automation, increased outflow of investment funds and jobs to Europe, and increased dividends to line the pockets of the rich and very rich.

In the name of social justice—the war on poverty, ignorance, disease, the hopelessness of those who dwell in city slums or in areas of worked out agricultural and mineral production—this bill would put the Federal Government in a fiscal straitjacket, denying to the Government the revenues required for any successful assault on poverty and its ugly bulwarks.

In the name of tax reform, this bill would, for at least a generation, dull the spur for real reform. Professed liberals will fain surprise in future wars for reform when they find themselves deserted by some of their current allies, even as the armies of David withdrew from Bathsheba's husband, leaving him naked and alone before the walls.

If the pattern of this bill is followed, we will likely witness, within the next few years, a worsening of our economy. We may well find ourselves repeating the 1954–57 pattern of nonsustainable productive capacity and increased unemployment.

Government—society organized for political purposes—does not exist for economic reasons alone, and I would never equate economic prosperity with the good life. But a society does not long live when it supports a politicoeconomic system which gives to the man who has one loaf two, while withholding from the man who has half a loaf or none.

Ideals and attitudes are as important as economics. The cynicism of some of the backers of this bill will be long remembered by those who are now without effective representation in Washington. Propaganda, like morphine, soon wears off. It will not be long before the majority of our citizenry awake to the realization of reality and know

that their bag is still empty and there never really was a snipe in the woods at all.

We decry and deplore waste and inefficiency in Government spending—and rightly so. But those who are so enamored of aggregates and mesmerized by macroeconomic manipulation in the private sector seem to assume that they have discovered in a tax cut economic perpetual motion—without waste, without inefficiency, without friction. All we need to do, we are told, is to release the "brake" of taxation on the economy and the private sector will expand in exactly the right ways to cure unemployment, without inflation of course, and will with perfect equity insure the good life for all, without Government interference or activity.

And all this without error in decisionmaking. Where was Adam Smith's "unseen hand" when the Edsel automobile was stillborn?

The theory behind a tax cut of this type and magnitude, under conditions existing today, will not stand close examination. Indeed, it is difficult to pin down the theory upon which some base their support for this bill.

Regardless of theory, the practical results of a tax cut of the type proposed will be diametrically opposed to the ostensible goals of many of its proponents. The implementation of this fiscal folly is a reckless gamble with our entire national economy.

In theory, assuming we are all Keynesians, and assuming further that conditions today fit the situation envisioned by Lord Keynes when he tried to adapt economic theory to fit the world stagnation of the late 1920's and early 1930's, a deficit will inflate the economy. This deficit can be achieved by increased spending or decreased revenues. But conditions are far different in these days of dynamic expansion.

The result of this bill will be to transfer yet another large slice of national production and wealth from those who produce wealth to those who parasitically participate in its enjoyment.

II. THE ADMINISTRATION POSITION

From the early and recurring rumors of a tax cut which gained wide circulation in the early fall of 1962 to the present time, it has been difficult to understand from statements issued by spokesmen for the administration the specific purposes of this proposed tax reduction.

At times this bill seems to have been regarded as a vehicle for long-range tax reform.

At other times it appers to have been sold as a hedge against more or less imminent recession.

At still other items, it appears to be straight Keynesian deficit financing for the avoidance of low-level equilibrium in the economy.

Under current conditions, and in the form in which this bill now exists. This legislation makes a mockery of any and all these purported positions.

The late President Kennedy in his tax message of January 24, 1963, stated:

> My recommendation for early revision of our tax structure is not motivated by any threat of imminent recession * * *.

But by March, when some of the indicators seemed to hang a bit, he seemed to have something else in mind, telling us:

> If we don't have the tax cut, it substantially, in my opinion, increases the chance of a recession * * *.

By May it became apparent that 1963 would be a good business year, and Secretary Dillon came back to the original theme. On May 7, 1963, the Secretary of the Treasury—a consistent follower of Republican theory and doctrine—told the Chamber of Commerce of New York:

> Above all, it must be borne in mind that the President's program is not intended—and is not designed—merely as a quick and temporary shelter against recession. It was designed—and has always been intended—as a permanent program to raise our long term rate of overall economic growth.

But again, the late President Kennedy on September 9 expressed concern that without a tax cut in 1963 "we may move into a period of economic downturn."

Meanwhile, Dr. Heller was working the Keynesian theme. I must say he has stuck pretty closely to this line, which he set out most explicitly in an article which appeared in November 1962 in Nation's Business:

HOW CUT WOULD SPUR GROWTH

> The U.S. economy has consistently fallen short of its employment, production, income, and profits goals in the past 5 years. A sizable cut in tax liabilities both of households and businesses throughout the Nation would push the economy toward more robust activity in three main ways—ways which would bring business stronger markets, expanded investment opportunities and healthier profits:
>
> 1. Tax reduction would increase the disposable income—the take-home pay of consumers. Careful analysis of past experience indicates that consumers consistently spend from 92 to 94 percent of their disposable income. History also shows that when this income is increased, a high proportion of the increase is promptly spent.
>
> When consumers spend this income, markets strengthen, production rises, new jobs are created, and income and profits rise accordingly. This creates added cycles of private spending. Boosted spending and income results in what economists call the "multiplier effect." It produces an increase in gross national product of perhaps two or three times the original reduction in taxes. Gross national product, the total output of goods and services, is, of course, a major indicator of growth.
>
> 2. By strengthening sales and pushing output closer to capacity, tax reduction spurs investment in inventories and in new equipment and new plants. This impact on investment in productive capacity is called the "accelerator effect." The increased production of capital goods expands gross national product, stimulates further consumption and increases profits. It reduces the deterrent effect of excess capacity,

which has tended to discourage investment in productive facilities during the past 5 years or so.

3. Reducing personal and corporate taxes raises profit margins for businessmen and enlarges the supply of internal business funds available for investment. Tax reduction thus strengthens the incentive to invest in two ways: Businessmen have money available to undertake the risks of new investment. And there is the prospect of larger after-tax returns to be earned on new productive facilities.

So, tax reduction would help business directly by reducing the tax load on business enterprise and indirectly by stimulating demand for both consumer goods and capital goods, thereby boosting the volume of sales and output. Indeed, tax cuts achieve their stimulating effect mainly by inducing business to employ, produce, and innovate.

President Johnson stated in his Economic Report, "The tax cut will give a sustained lift, year in and year out to the American economy." This would seem to indicate that this action is in the nature of some sort of permanent reform.

Its proponents claim this bill will:

1. Stimulate economic growth.
2. Balance the budget.
3. Relieve unemployment.
4. Solve the balance-of-payments problem.
5. Avoid inflation.
6. Promote tax equity.

This is just what the doctor ordered, and it all comes in one little pill which causes the happy patient no pain whatsoever.

III. ECONOMIC EXPANSION

It is claimed that this bill would stimulate the economy in two ways. First, consumers, having more money to spend by virtue of a tax cut, will spend more and thus create additional demand. Second, investors will have more money to invest by virtue of being able to show a better rate of return.

But these are only the first steps. At that point the "multiplier" and the "accelerator" take over and we bootstrap ourselves up to the point where—within a relatively short time, of course—we increase our gross national product by at least three times the amount of the tax cut.

If there were a shortage of funds for investment, a tax cut for corporations might induce more investment. If there were a shortage of spendable personal income, a tax cut for consumers might create increased consumer demand.

But do these conditions prevail? Not at all. Corporations are highly liquid and rarely need to go to the capital markets for outside money. Corporations sold only about $1 billion of new common stock last year. Personal income, although poorly distributed, continues to rise. The irony of the tax cut is that it would give increased spending and purchasing power to those who need it least and who would use it sparingly. The man on the bottom of the poverty pile pays no income taxes now. He needs income, not a tax cut.

Now, what is the likelihood of complete, or nearly complete, and prompt, spending of increased personal income? The prospects are not good.

Already personal savings are high. Increased take-home pay by way of a tax cut is apt to increase savings, at least for several months. Of course, the man who is out of a job, or the man who is trying to get by on such a small income that he has no tax to pay, would spend more money if he could get it, but this bill does nothing for him.

Savings are up 25 percent in the past 3 years. Secretary Dillon, himself, in an interview reported in Banking for May 1963, said, "At present when our economy is not operating at full speed, it is characterized by what one might call an excess of savings."

If there is now an "excess of savings," why would it be thought that marginal income would be largely spent rather than saved?

I am not the only one who questions this aspect of this bill. As long ago as February 26, 1963, an article appeared in the Wall Street Journal emphasizing this point. Here are two paragraphs from that article:

> To many economists, the savings rise suggests that a tax cut to spur consumer spending—as proposed by the Kennedy administration—may not be particularly effective, at least in the middle and upper income brackets. If consumer demand continues to lag, they argue, a considerable part of extra income from reduced taxes would go into savings, rather than be spent.
>
> "The theory behind the tax cut idea is that it will stimulate demand," says J. Walter Thompson's Mr. Johnson. "But the savings accumulation suggests this may not happen." John R. Bunting, vice president of the Philadelphia Federal Reserve Bank, expresses "concern" that income consumers may receive through lower taxes "will be siphoned out of the spending stream" into more savings.

There is now no shortage of investment funds in the corporate structure. On the other hand, corporations are highly liquid. Profits are rising, and cash flows are rising even faster.

I do not see how hard statistics can be overlooked. In 1963, corporate cash flows, after allowing for taxes, amounted to about $60 billion. After record dividend payments, this left well over $40 billion in the hands of corporate management. Investment in plant and equipment amounted to only about $39 billion. Would anyone logically think that increasing cash flows by way of a tax cut would materially increase investment in plant and equipment—given these conditions?

We now have further statistical proof that a tax cut will induce little in the way of increased plant and equipment expenditures.

According to Dr. Heller, in addressing the Printing Industries of Metropolitan New York on May 20, 1963, a McGraw-Hill investment survey reported that business executives attributed $1.2 billion of the planned increase in plant and equipment expenditures for 1963 over actual expenditures for 1962 to the investment credit passed in 1962 by Congress and to the depreciation revisions instituted the same year by the Treasury Department. When one considers that the tax reduction given business as a result of these two changes in taxation amounted to about $2.25 billion, and this reduction in

revenues induced a 50-cent investment of each tax dollar lost, can we expect any better results from an across-the-board tax cut?

I can see no way by which this tax cut can increase the GNP by $30 to $40 billion—not without inflation—even if we accept Keynesian theory as valid and apply it to existing conditions.

The principal results of a tax cut for corporations will be increased dividends and increased foreign investment which adds to balance-of-payments difficulties. A side effect is further to entrench the Big Three's and make it more nearly impossible for new enterprises to grow up and challenge them. Competition will be increasingly a thing of the past.

Certainly a tax cut will have some effect on economic growth. But that effect, under current conditions, will be much smaller, and slower in developing, than we have been led to believe. A tax cut, especially one weighted largely in favor of those who need it least, is the most expensive and least efficient way imaginable to get an economic boost.

IV. BUDGET BALANCING

It is a bit difficult to understand how this proposed tax cut is to balance the budget.

Dr. Heller and other more or less straight Keynesians have reasoned that through the magic of the "multiplier" and "accelerator" a tax cut of about $11 billion will cause an increase in the GNP of $40 billion or so and this increased economic activity will, in turn, bring in enough taxes at the new, lower rates to balance or nearly balance the budget.

President Kennedy seemed to start out on this tack in his tax message to Congress last January. He stated, as I have already pointed out, "It would be a grave mistake to require that any tax reduction today be offset by a corresponding cut in expenditures." This is genuine Keynesian theory. A deficit-creating tax cut will spur the economy, but this stimulating action would be offset and negated by a corresponding cut in Government expenditures. If these two actions were taken at the same time, they would pretty well cancel each other out.

There was, last January, no evidence that the late beloved President Kennedy wanted to cut back on worthwhile programs. Indeed, his budgets emphasized positive programs of development and were partially responsible for our economic expansion since 1961.

Mr. Ford's group issued a pronouncement during last year's "millionaire's march on Washington" which stated:

> We, therefore, believe it possible to hold Federal expenditures in fiscal 1964 below the level set forth in the budget this January. We believe this would have been impossible without the current pressures for economics generated by a proposed tax reduction. We urge the Congress and the administration to work jointly to achieve this goal.

This rationale is interesting. We are urged to cut taxes, reduce revenues, run up larger deficits, and it is argued that this will put additional pressure on the President and the Congress to cut spending. Of course, the spending which some want to cut is in the fields devoted to the social advancement of the whole country, to the attack on poverty, ignorance, disease, and hopelessness.

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If we adopt the wrong kinds of expenditure reductions, we will certainly do untold harm to the Nation and to the economy. For we must continue to pursue worthwhile programs. Highways, education, health, etc., must not suffer if the Nation is to make any worthwhile progress. But these are the programs which will suffer under the kind of philosophy embraced by Mr. Ford.

V. THE "BRAKE" THEORY

We are told that our high tax structure acts as a "brake" on the economy, stifling both investment and consumer purchasing. Releasing this "brake" will, according to the argument, promote investment and increase final demand.

A favorite propaganda trick is to state a conclusion as the basis for a second conclusion, hoping that the first conclusion will be uncritically accepted as a proven fact. Those who try to sell this "brake" theory are indulging in just such sleight of hand.

We have heard the European countries praised for their swift postwar recovery, and for their wise fiscal policies which have reportedly promoted high rates of growth. How does the tax take of these countries compare with our own?

Secretary Dillon has testified that total taxes collected by all levels of government in the United States in 1961 amounted to 28 percent of gross national product. No major European country collected a smaller percentage—France, 35 percent; Germany, 35 percent; United Kingdom, 29 percent; Italy, 28 percent.

One might legitimately discuss the incidence of certain taxes, and argue that our tax structure needs to be reformed. But this is no argument for a reduction in total revenues. It is this latter situation which we face in this bill. Will those who now advocate tax cuts for the rich soon come before the Congress to propose replacing the revenue loss by a general excise tax, further to oppress the poor?

What about this "brake" theory so far as high bracket individual taxpayers in this country are concerned?

The regrettable fact is that the rich and the very rich do not now pay their fair share of the tax burden. And this bill makes the situation more, not less, inequitable.

The very rich now pay a low percentage of their realized income in taxes. From table I below, furnished by the Treasury Department, I have developed table II which shows just how light is the taxload at the upper end of the income scale.

The "brake" theory simply does not appear plausible unless one examines the lower end of the tax and income scale. It is here that we may need to restore the broad base of purchasing power which existed prior to World War II.

TABLE I.—*Tax savings and increase in after-tax income under House bill*

[Married couple with 2 dependents, with typical dividends, capital gains and other income,[1] and typical itemized deductions]

Adjusted gross income [1]	Present law		House bill		Tax cut or increase in after-tax income		
	Tax	After-tax income [2]	Tax	After-tax income [2]	Amount	Percentage tax cut	Percentage increase in after-tax income
$3,000	0	$3,131	0	$3,131			
$4,000	$143	3,987	$103	4,027	$40	28	1
$5,000	299	4,827	219	4,907	80	27	2
$6,000	455	5,671	339	5,787	116	26	2
$7,500	719	6,971	569	7,067	150	21	2
$10,000	1,193	8,993	972	9,214	221	19	2
$12,500	1,657	11,079	1,373	11,363	284	17	3
$15,000	2,196	13,189	1,830	13,555	366	17	3
$17,500	2,745	15,288	2,296	15,737	449	16	3
$20,000	3,369	17,344	2,820	17,893	549	16	3
$25,000	4,755	21,271	3,983	22,043	772	16	4
$30,000	6,322	25,139	5,297	26,164	1,025	16	4
$40,000	10,026	32,305	8,392	33,939	1,634	16	5
$50,000	14,254	38,947	12,217	40,984	2,037	14	5
$75,000	23,799	57,421	20,672	60,548	3,127	13	5
$100,000	33,965	79,247	29,670	83,542	4,295	13	5
$200,000	63,318	184,262	56,675	190,905	6,643	11	4
$500,000	154,249	567,116	138,216	583,149	16,033	10	3
$1,000,000	261,929	1,239,659	238,037	1,263,551	23,892	9	2

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.

[2] After-tax income exceeds adjusted gross income for very-high-income-tax payers because 50 percent of the long-term capital gains, which constitute a high proportion of income for such taxpayers, is included in adjusted gross income under present law and 40 percent is included under the House bill.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 11, 1963.

TABLE II.—*Effective tax rates under H.R. 8363*

[Married couple with 2 dependents, with typical dividends, capital gains, and other income,[1] and typical itemized deductions]

Adjusted gross income [1]	Realized income [2]	Tax under H.R. 8363	Tax as percentage of realized income	Adjusted gross income [1]	Realized income [2]	Tax under H.R. 8363	Tax as percentage of realized income
$3,000	$3,131	0	0	$25,000	$26,026	$3,983	15.3
$4,000	4,130	$103	2.5	$30,000	31,461	5,297	16.8
$5,000	5,126	219	4.3	$40,000	42,331	8,392	19.8
$6,000	6,126	339	5.5	$50,000	53,201	12,217	23.0
$7,500	7,636	569	7.4	$75,000	81,220	20,672	25.5
$10,000	10,186	972	9.5	$100,000	113,212	29,670	26.2
$12,500	12,736	1,373	10.8	$200,000	247,580	56,675	22.9
$15,000	15,385	1,830	11.9	$500,000	721,365	138,216	19.2
$17,500	18,033	2,296	12.7	$1,000,000	1,501,588	238,037	15.9
$20,000	20,713	2,820	13.6				

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.

[2] Realized income exceeds adjusted gross income largely because adjusted gross income includes only 40 percent of capital gains under H.R. 8363 (50 percent under existing law).

NOTE.—Several items, such as tax-exempt interest, ½ of long-term capital gains, including so-called statutory gains which often have no logical relationship to capital transactions, depletion, and intangible drilling costs, are omitted from adjusted gross income and from realized income.

Source of basic data: Office of the Secretary of the Treasury, Office of Tax Analysis. See table on p. 709 of Finance Committee hearings.

The proponents of this legislation also err when they attempt to apply the "brake" theory to corporate taxation. Although stated corporate rates have not been reduced in recent years, the actual tax burden has been considerably lightened by changes in laws and regulations applicable to depreciation, and to the investment credit. Such

positive Government programs as stepped up research and development expenditures, most of which go to and through industry, have relieved corporations of the necessity for spending their own funds for activities they would otherwise have to budget for and undertake.

But let us look at corporation taxes as they are assessed against corporate gross income, not as they appear to be levied as a percentage of certain bookkeeping figures.

Just as it is necessary to go behind the stated rates and look at total income in order to know just what effective tax rate any individual pays, so is it necessary to look behind the stated 52 percent rate for corporations to determine just what the true tax and profit figures are.

Effective tax rates for corporations have been reduced quite steadily and regularly during the past few years. There were rapid amortization procedures during the Korean war, accelerated depreciation enacted in 1954, administrative changes in depreciation approved by the Treasury last year, the investment credit enacted last year, and the further liberalizing of this credit contained in the subject bill. Of course, we have retained the same stated rates, but the effect of these rates has been drastically altered, thus materially reducing the effective rate.

It seems difficult for some, economists and laymen alike, to understand that these actions have the effect of reducing the burden of income taxation on corporations. But the effect is just as real as is the effect on individuals when a new deduction, or an increase in an exemption, is enacted.

As proof of this, one has merely to look at the profits curve on page 7 of the Economic Indicators. Due to the fact that depreciation guidelines were revised so drastically last year, a new curve had to be started. The corporate profit figures are not now comparable to the figures prior to 1962.

Some facts relative to corporate profits, taxes, and cash flows are shown on table III below.

TABLE III

[In billions of dollars]

	Gross national product	Dividends paid	Corporate profits after tax	Corporate profits after tax plus capital consumption allowances	Dividends as a percent of gross national product	Dividends as a percent of corporate profits after tax	Corporate profits after tax plus CCA as a percent of gross national product	Dividends as a percent of corporate profits after tax plus CCA
1946	210.7	5.8	13.4	18.6	2.8	43.3	8.8	31.2
1947	234.3	6.5	18.2	24.5	2.8	35.7	10.5	26.5
1948	259.4	7.2	20.5	28.2	2.8	35.1	10.9	25.5
1949	258.1	7.5	16.0	24.5	2.9	46.9	9.5	30.6
1950	284.6	9.2	22.8	32.2	3.2	40.4	11.3	28.6
1951	329.0	9.0	19.7	30.7	2.7	45.7	9.3	29.3
1952	347.0	9.0	17.2	29.6	2.6	52.3	8.5	30.4
1953	365.4	9.2	18.1	32.2	2.5	50.8	8.8	28.6
1954	363.1	9.8	16.8	32.7	2.7	58.3	9.0	30.0
1955	397.5	11.2	23.0	41.4	2.8	48.7	10.4	27.0
1956	419.2	12.1	23.5	43.5	2.9	51.5	10.4	27.8
1957	442.8	12.6	22.3	44.1	2.8	56.5	10.0	28.6
1958	444.5	12.4	18.8	41.4	2.8	66.0	9.3	30.0
1959	482.7	13.7	24.5	48.7	2.8	55.9	10.1	28.1
1960	502.6	14.5	22.0	47.6	2.9	65.9	9.5	30.5
1961	518.2	15.3	21.8	48.6	3.0	70.2	9.4	31.5
1962	554.9	16.6	24.6	55.4	3.0	67.5	10.0	30.0
1963	575.7	17.4	26.1	58.0	3.0	66.7	10.1	30.0

Source: Staff of the Joint Committee on Internal Revenue Taxation.

This table shows that corporate profits after taxes just barely doubled between 1946 and 1963, while GNP almost tripled. This has led many to believe, and to state, that corporate profits have not kept pace with GNP. This has been cited as one of the reasons for our alleged slow rate of growth in recent years. It has been said that this is one reason for the lack of sufficient investment in new plant and equipment, and that this has, in turn, been one of the main causes of unemployment. Thus, the need for a tax cut for corporations.

But corporate profits after taxes plus capital consumption allowances have kept pace with GNP, running at a pretty steady 10 percent. Furthermore, dividends have kept pace with GNP, running about 3 percent.

If one claims that only the profit figures are to be considered, then he must of necessity condemn corporate management for paying out too much in dividends. Dividends being paid out today amount to about two-thirds of corporate profit after taxes. As a percentage of corporate profit after taxes, dividends have gone up 50 percent since 1946. If bookkeeping profit is in reality the key figure, then dividend payments are, without question, too high and more earnings ought to be retained.

The fact is that corporations are highly liquid, and cash flows have in recent years exceeded investment in new plant and equipment.

As for effective taxation, corporations got about $2.4 billion in tax reduction under the 1954 Internal Revenue Code. Last year they got another $2.25 billion as a result of changes in depreciation and enactment of the investment credit. What is the effective corporate tax rate? In 1946, corporate taxes amounted to about 33 percent of profits plus capital consumption allowances. Today, the comparable figure is about 29 percent. This is an effective tax reduction of about 12 percent.

Not only have we been cutting tax rates in a disguised form, but these cuts have not really been effective—or they have been inefficient—in promoting investment in plant and equipment. We have concrete proof of this.

The most optimistic statements I have seen about the effects of the $2.25 billion tax reduction given corporations last year have been to the effect that this cut has induced $1.2 billion of increased spending for plant and equipment. This is an efficiency of about 50 percent. Can we expect any better performance from this year's proposed cuts? I think not.

We give corporations a tax cut of $2 to induce them to spend $1 for plant and equipment. Hopefully this kind of expenditure, costly as it is to the Government, will create jobs. Actually it has not, and likely will not, at least not in manufacturing. We have lost about 1 million production jobs in manufacturing during the past 6 or 7 years, despite increased production.

Equity does not dictate a reduction in corporate tax rates, because dividends are maintaining pace with the economy as a whole, and the high income individuals, who own the large blocks of stock, are being given a drastic reduction in their own rates under the bill, H.R. 8363.

Economic reasons also fail to convince. A tax cut is a most inefficient way to induce expenditures by corporations. And plant and equipment expenditures in industry are not likely to create many jobs. Indeed, industry is daily accelerating the trend toward auto-

mation, thereby not only failing to create jobs, but even failing to maintain current job levels.

VI. UNEMPLOYMENT AND POVERTY

One of the more appealing arguments in favor of a mammoth tax cut is that this action will result in a drastic decrease in unemployment. It is a sad commentary on our economic and social system that so many who want and need jobs are unable to find them. Even worse, in some respects, is the fact that in many cases when jobs are available those who need those jobs are not qualified to fill them.

This is an appealing argument, because we want to insure, insofar as we are able, the right and the opportunity for each of our citizens who wants and needs a job to have one. We want our people to be self-supporting, self-reliant, prosperous, and secure.

But it is far from certain that the tax cut will reduce our excessive unemployment. Indeed, in my view, it is more likely, after about 18 months, to cause increased unemployment. A tax cut is not the place to start—or to stop a war on poverty and unemployment.

We need to look squarely at our unemployment and see just what it consists of and what has caused it. In what geographical, age, health, and ethnic areas is it concentrated? Can increased general demand cure it without causing inflation?

To begin with, we are not suffering unemployment because of a recession or depression. On the contrary, the economic indicators are, by and large, at alltime highs. We are not in that desperate condition we faced during the great depression when almost any gamble seemed in order—no matter how inefficient, or how dangerous.

We are not suffering unemployment because of lack of capital or productive capacity. The corporate sector is highly liquid; and about 12 to 15 percent of plant capacity is idle. Certainly our basic productive structure is sound, and we would have no trouble increasing production in almost any area where demand is spurred. But would this put many of the presently unemployed to work? Some confuse poverty and unemployment, and the two are closely linked. But we should always keep in mind that we do not have poverty for lack of production. Our situation economically is almost unique in recorded history. Characteristically and historically, there has been, in every society, a problem of sufficient total production. This is not our problem. We have an almost unlimited capacity to produce. Our basic problem is distribution, and the understanding of this fact is a necessary prerequisite to formulating any workable plan for an attack on unemployment and poverty. There must be a proper distribution of the fruits of national production, and this is best achieved in our society by a proper distribution of jobs which pay a decent wage.

There are two general ways of attacking unemployment. Such an attack can be directed toward increasing production and creating additional jobs. A slightly different type of attack focuses on a more equitable distribution of jobs without materially increasing total national production. We need to launch this two-pronged attack.

A tax cut does not fit into this picture. I am sorry to say that it will likely make matters worse. This is particularly true of the type of tax cut contained in the subject bill.

The first type of attack must be concentrated on increased production in the public sector, for this is where our unfulfilled demands now largely lie—for better rapid transit systems, better housing for low income groups, better educational facilities at all levels, better highways, more and better hospitals and nursing homes, more clean drinking and industrial water. It is here that jobs could readily, directly, and with profit to society, be created. But this takes public funds, which will be less available after passage of the tax bill.

Furthermore, to the extent this tax cut is effective in spurring increased investment, we are likely to build up a capacity which cannot be sustained by demand in the private sector, just as was the case in 1956–57. This may worsen unemployment in the not distant future, and especially so when accompanied by policies of economic retrenchment and monetary squeeze.

Those who would fight unemployment and poverty only by trying to increase overall demand do not understand the nature of the problem or the composition of the unemployed segment of our labor force, and the poverty-stricken in the midst of our affluence.

Present unemployment is largely structural. It is concentrated in certain geographical localities, certain age groups, certain social and ethnic categories. Unemployment is daily being worsened, or at least made more difficult to cure, by technological advances—automation, if one uses the term loosely.

From 1953 to 1962 investment in scientific research and development tripled. As a result, partially, of this effort, we are now losing 2 million jobs each year because of the laborsaving effects of increasing productivity. Manufacturing employs about 1 million fewer production workers than was the case just 6 or 7 years ago, despite vastly increased production.

This may be all to the good, and I know of no latter-day Luddites, but we must recognize the fact that no longer does increased production through increased overall demand create jobs in large numbers for the unskilled. The seeds of inflation would be sown by a shortage of skilled labor long before profitable work could be found for the bulk of presently unemployed. Altogether too large a proportion of our unemployed are not qualified to hold down productive positions in our highly mechanized and automated economy, even if those jobs could, somehow, be created.

Unemployment, and poverty, sprouting from such roots, cannot be cured by a tax cut. The type of unemployment problem we have requires more specific treatment. We must concentrate more on the public sector as well as upon encouraging and assisting private enterprise to play its part as the mainstay of our economy.

The other half of our two-pronged attack centers around encouraging certain types of persons to delay or refrain from entering the labor market—some temporarily, some permanently. After all, unemployment is a product of the participation rate—the numbers of people who say they want a job—as well as of the total number of jobs available.

One obvious place to begin here—and with profit to society—is to set up programs designed to delay the entry of young people into the labor market until they are better qualified. This would not only make for a more stable labor force, but it would also assist these young people individually to achieve a more well-rounded life, as well

as specifically to fit them for more productive jobs when they do enter the labor force. We have been altogether too timid about moving into this area. Education is the key here, not a tax cut. This kind of realistic and highly beneficial attack on unemployment will cost money, thus indicating the need for more, not less, Government revenue.

Another approach of this sort is to assist those wives and mothers who wish to devote more time to their homes and children and who really do not want to work, but who feel they must, to stay out of the active labor force. We could help them in their home life, and society as a whole, if we took steps to insure that the head of the household earned a proper wage so the family could maintain a decent standard of living without the mother having to leave the home every day to seek employment.

It is not generally realized, perhaps, just to what extent women have increasingly come into the labor force since World War II. At the same time, relatively more men have been dropping out of the labor force. This may not be socially desirable.

In 1947, the participation rate for women was 31.0 percent. This figure rose in 1962 to 36.7 percent. During the same period of time, the participation rate for men went down from 84.5 percent in 1947 to 79.3 percent in 1962.

Let me make it very, very plain that I favor full employment opportunities for men and women alike—the opportunity for a decent job for any man or woman who is able and willing to work. But I am opposed to a social and economic structure which forces wives and mothers to leave their homes and children daily to seek work because the head of the household is not paid a wage or salary which will keep the family in decent comfort. I am opposed, too, to a tax system that penalizes the parent as a taxpayer.

A tax cut for corporations and the high income brackets hardly fits in here. If a tax cut must be had, then tax relief for parents of the largest numbers of children would be fairest and of greatest benefit.

In this connection, also, we need to look more closely into the area of the minimum wage, overtime pay, and the length of the workweek.

Unemployment can be partially cured, of course, by increasing production. But, as I have pointed out, the increased production that is needed is not in the private sector where there are neither shortages nor reasonably full utilization of capacity, but in the public sector. A tax cut does not fit in here at all. Worse still, the capacity of the Government to provide for our pressing public needs will be seriously and permanently impaired by a drastic reduction in revenue.

We cannot cure unemployment and poverty by reducing revenues and leaving ourselves defenseless, bereft of our most useful weapon, before the onslaught of the next recession.

VII. BALANCE-OF-PAYMENTS CONSIDERATIONS

Because the economic royalists who are now running the Treasury Department refuse to take positive action to stem the outflow of private capital, or to take such other steps as might be indicated, the balance-of-payments problem persists. Indeed, our situation can hardly be said to have improved at all.

During 1962 there was some apparent improvement—more apparent than real, because there were several special operations, such as advance repayments well ahead of schedule, on obligations of certain foreign governments.

During the first half of 1963, capital flows reached runaway proportions. The apparent improvement during the last half of the year may be illusory, representing only a partially balancing of forces at work earlier in the year.

It is felt by proponents of the subject bill that a tax cut will help materially in solving our balance-of-payments problem. It will not.

It is felt, first, that the cost of production will be lower and our goods will be more competitive in world markets. We have not achieved lower prices as a result of the investment credit and depreciation changes, and both had the effect of reducing corporate taxes. We will not achieve lower prices as a result of this tax cut.

Even if we were to achieve lower prices through any mechanism whatsoever, this would not materially increase exports. Other countries use direct controls to regulate imports of merchandise and exports of capital. Witness the "chicken war." We will certainly not achieve a sufficiently large favorable balance in goods and services to overcome other areas of deficiency.

Proponents of this bill also claim that the economy will be so booming—without inflation, of course—and domestic investment will pay off so handsomely as a result of the enactment of this bill that no longer will money go abroad to find a higher rate of return.

This is an argument which is so fantastic that it is difficult to answer.

Investment decisions are dictated by many considerations—markets, raw materials, costs, taxes—and so long as out investors can earn high rates of return abroad, and build up their investment without the necessity of paying U.S. taxes, there will be continued encouragement to send funds abroad.

In 1962, the Congress took a timid step in the direction of closing off some of the tax haven operations abroad, but this did not really reach the direct investment problem.

In 1963, after it became apparent that interest rates could not be pushed high enough to stop portfoilo outflows without doing untold damage to the domestic economy, the administration proposed the so-called interest equalization bill. The threat of this legislation appears to have had some effect on portfolio outflows, but this effect now appears to be wearing thin.

It seems to be obvious that a positive program of regulation of capital flows is the answer to our direct and portfolio outflow of capital. But it would appear that no action along this line will be taken. Barring such action, the approach of indirect regulation by taxation is the next best thing. It is not sufficiently selective. Methods of avoidance will be found. But if this is the best we can do, let us at least do that.

All other modern industrial countries invoke positive controls whenever it appears to be in their interest to do so. The fact that we do not is difficult to understand or justify.

The most likely effects of the bill on the balance of payments are—

1. Increased imports.
2. No material change in exports. The domestic price level is, to the extent the bill is at all effective, likely to be inflated. This will likely make exports move more slowly.
3. Higher interest rates. This may slow down portfolio outflows, but it will, in turn, slow down the whole domestic economy.

All in all, it would seem that the bill will not help achieve a balance in our international payments.

VIII. TAX REDUCTION AND INFLATION

If I understand correctly the position of the proponents of this bill, it is not that it will help to curb inflation; rather, it will boost economic activity without causing inflation.

It is claimed that, because we now have high unemployment and unused plant capacity, we can have greatly increased production without inflationary pressures.

Although inflation does not seem to be a matter of major concern at the moment, the Consumer Price Index has crept up consistently, and some commodities are now beginning to push upward in price.

But what will happen if the tax cut really does react in the way its proponents hope it will?

Can any really large dent be made in the ranks of the unemployed without putting pressure on certain skills and categories of workers?

There are some relatively scarce categories of trained personnel, and pressures will be felt in these categories even though we still have several million of the unskilled and uneducated unemployed.

But what really concerns me more is the tight rope which must be walked—it is felt—by our money managers. My fear is that, in attempting to guard against monetary inflation, the Federal Reserve Board will raise interest rates and restrict the supply of money so that, having rid our house of the supposed evil spirit of high taxes, we will find it filled with the even more malevolent spirits of high interest rates, tight money, restrictive debt management, and reduced spending. Truly our final state will be worse than our former.

IX. EQUITY

Although economic considerations are important when considering the tax structure, equity must not be ignored.

There is little equity in this bill.

The new minimum standard deduction gives some relief to the lowest income groups, but it is not enough.

There is no better way to show the basic inequity of the changes in the rate structure which this bill makes—by far the most important part of the bill—than to note the increase in after-tax income or take-home pay which this bill gives to various income groups.

The tables below were prepared by the staff of the Joint Committee on Internal Revenue Taxation, and show (col. 8) the treatment which taxpayers in various income groups will receive from the rate reductions.

TABLE IV.—*Individual income tax liability: Under present-law tax rates, under H.R. 8363 tax rates, and under uniform percentage increase in taxable income after present-law tax; selected levels of taxable income, 1965, single person*

Taxable income	Tax		Taxable income after tax		Reduction in tax or increase in taxable income after tax				
					Under H.R. 8363			Under uniform percentage increase in taxable income after tax (5.95 percent)	
	Present law	H.R. 8363	Present law	H.R. 8363	Amount	As percent of present-law tax	As percent of taxable income after present-law tax	Amount	As percent of present-law tax
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$500	$100	$70	$400	$430	$30	30.0	7.5	$24	24.0
$1,000	200	145	800	855	55	27.5	6.9	48	24.0
$1,500	300	225	1,200	1,275	75	25.0	6.3	71	23.7
$2,000	400	310	1,600	1,690	90	22.5	5.6	95	23.8
$4,000	840	690	3,160	3,310	150	17.9	4.7	188	22.4
$6,000	1,360	1,130	4,640	4,870	230	16.9	5.0	276	20.3
$8,000	1,960	1,630	6,040	6,370	330	16.8	5.5	359	18.3
$10,000	2,640	2,190	7,360	7,810	450	17.0	6.1	438	16.6
$12,000	3,400	2,830	8,600	9,170	570	16.8	6.6	512	15.1
$14,000	4,260	3,550	9,740	10,450	710	16.7	7.3	580	13.6
$16,000	5,200	4,330	10,800	11,670	870	16.7	8.1	643	12.4
$18,000	6,200	5,170	11,800	12,830	1,030	16.6	8.7	702	11.3
$20,000	7,260	6,070	12,740	13,930	1,190	16.4	9.3	758	10.4
$22,000	8,380	7,030	13,620	14,970	1,350	16.1	9.9	810	9.7
$26,000	10,740	9,030	15,260	16,970	1,710	15.9	11.2	908	8.5
$32,000	14,460	12,210	17,540	19,790	2,250	15.6	12.8	1,044	7.2
$38,000	18,360	15,510	19,640	22,490	2,850	15.5	14.5	1,169	6.4
$44,000	22,500	18,990	21,500	25,010	3,510	15.6	16.3	1,279	5.7
$50,000	26,820	22,590	23,180	27,410	4,230	15.8	18.2	1,379	5.1
$60,000	34,320	28,790	25,680	31,210	5,530	16.1	21.5	1,528	4.5
$70,000	42,120	35,190	27.880	34,810	6,930	16.5	24.9	1,659	3.9
$80,000	50,220	41,790	29,780	38,210	8,430	16.8	28.3	1,772	3.5
$90,000	58,620	48,590	31,380	41,410	10,030	17.1	32.0	1,867	3.2
$100,000	67,320	55,490	32,680	44,510	11,830	17.6	36.2	1,944	2.9
$150,000	111,820	90,490	38,180	59,510	21,330	19.1	55.9	2,272	2.0
$200,000	156,820	125,490	43,180	74,510	31,330	20.0	72.6	2,569	1.6
$300,000	247,820	195,490	52,180	104,510	52,330	21.1	100.3	3,105	1.3
$400,000	338,820	265,490	61,180	134,510	73,330	21.6	119.9	3,640	1.1
$600,000	520,820	405,490	79,180	194,510	115,330	22.1	145.7	4,711	.9
$800,000	696,000	545,490	104,000	254,510	150,510	21.6	144.7	6,188	.9
$1,000,000	870,000	685,490	130,000	314,510	184,510	21.2	141.9	7,735	.9

Source: Staff of the Joint Committee on Internal Revenue Taxation, Oct. 4, 1963.

Table V.—*Individual income tax liability under present law tax rates, under H.R. 8363 tax rates, and under uniform percentage increase in taxable income after present law tax; selected levels of taxable income; 1965; married couple—joint return*

Taxable income	Tax		Taxable income after tax		Reduction in tax or increase in taxable income after tax				
					Under H.R. 8363			Under uniform percentage increase in taxable income after tax (5.95 percent)	
	Present law	H.R. 8363	Present law	H.R. 8363	Amount	As percent of present law tax	As percent of taxable income after present law tax	Amount	As percent of present law tax
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$1,000	$200	$140	$800	$860	$60	30.0	7.5	$48	24.0
$2,000	400	290	1,600	1,710	110	27.5	6.9	95	23.8
$3,000	600	450	2,400	2,550	150	25.0	6.3	143	23.8
$4,000	800	620	3,200	3,380	180	22.5	5.6	190	23.8
$8,000	1,680	1,380	6,320	6,620	300	17.9	4.7	376	22.4
$12,000	2,720	2,260	9,280	9,740	460	16.9	5.0	552	20.3
$16,000	3,920	3,260	12,080	12,740	660	16.8	5.5	719	18.3
$20,000	5,280	4,380	14,720	15,620	900	17.0	6.1	876	16.6
$24,000	6,800	5,660	17,200	18,340	1,140	16.8	6.6	1,023	15.0
$28,000	8,520	7,100	19,480	20,900	1,420	16.7	7.3	1,159	13.6
$32,000	10,400	8,660	21,600	23,340	1,740	16.7	8.1	1,285	12.4
$36,000	12,400	10,340	23,600	25,660	2,060	16.6	8.7	1,404	11.3
$40,000	14,520	12,140	25,480	27,860	2,380	16.4	9.3	1,516	10.4
$44,000	16,760	14,060	27,240	29,940	2,700	16.1	9.9	1,621	9.7
$52,000	21,480	18,060	30,520	33,940	3,420	15.9	11.2	1,816	8.5
$64,000	28,920	24,420	35,080	39,580	4,500	15.6	12.8	2,087	7.2
$76,000	36,720	31,020	39,280	44,980	5,700	15.5	14.5	2,337	6.4
$88,000	45,000	37,980	43,000	50,020	7,020	15.6	16.3	2,559	5.7
$100,000	53,640	45,180	46,360	54,820	8,460	15.8	18.2	2,758	5.1
$120,000	68,640	57,580	51,360	62,420	11,600	16.1	21.5	3,056	4.5
$140,000	84,240	70,380	55,760	69,620	13,860	16.5	24.9	3,318	3.9
$160,000	100,440	83,580	59,560	76,420	16,860	16.8	28.3	3,544	3.5
$180,000	117,240	97,180	62,760	82,820	20,060	17.1	32.0	3,734	3.2
$200,000	134,640	110,980	65,360	89,020	23,660	17.6	36.2	3,889	2.9
$300,000	223,640	180,980	76,360	119,020	42,660	19.1	55.9	4,543	2.0
$400,000	313,640	250,980	86,360	149,020	62,660	20.0	72.6	5,138	1.6
$600,000	495,640	390,980	104,360	209,020	104,660	21.1	100.3	6,209	1.3
$800,000	677,640	530,980	122,360	269,020	146,660	21.6	119.9	7,280	1.1
$1,000,000	859,640	670,980	140,360	329,020	188,660	21.9	134.4	8,351	1.0

Source: Staff of the Joint Committee on Internal Revenue Taxation, Oct. 4, 1963.

These tables show some very disturbing results. Whereas a married couple filing a joint return, having a taxable income subject to ordinary income rates of $3,000 per year, will gain $150 from the rate reductions in the bill, the more affluent couple with a taxable income of $300,000 will pick up an extra $42,660. As a percentage of taxable income, this would mean an extra 6.3 percent to this $3,000 couple, but an extra 55.9 percent to the $300,000 couple. For the really rich, the gain would be more than 100 percent in take-home pay after tax income.

It has been pointed out, and I want this clearly understood, that the table does not reflect the full picture insofar as the rich and very rich are concerned. The typical high income taxpayer is able to take advantage of many loopholes in the law. The affluent do not pay taxes in accordance with the regular, ordinary income tax rates. But the table does show the true picture with respect to whatever taxable income any taxpayer has to which the published ordinary income rates apply.

The majority of Americans pay their taxes in accordance with the stated rates. This is not true, however, of the "typical" taxpayer with a very large income. But the gain which would be realized under the tax bill by those in the upper income groups would be tremendous. In my view, it would be grossly unfair.

A far more equitable way of reducing taxes, if we can afford a large reduction in governmental revenue, would be to raise the personal exemption for each taxpayer and each dependent. This would give everyone a more nearly equal and equitable amount of tax benefit.

Referring again to the table, it shows that a taxpayer with a small income would receive a very small percentage increase in take-home pay. It would be a percentage increase of a small amount. But those who have large taxable incomes would receive a large percentage increase in take-home pay. It would be a large percentage of a large amount.

Instead of the pending bill making our tax system more progressive, more equitable, more stimulative primarily of the consumer element of our economy, it would do just the reverse. Its enactment would bring a more regressive tax law, a more unfair tax law, a more unjust tax law, and would allow those with really large incomes, who now do not pay their fair share now to pay less.

X. SUMMARY OF RATE REDUCTION ASPECTS OF THE BILL

With 3 years of rapidly expanding economy behind us and the prospect of another good year—perhaps the best in our history—before us, it would appear that our economy is doing quite well.

From the viewpoint of those who would use fiscal policy actively in a countercyclical way, this would appear to be the worst possible time to initiate and carry through a tax cut.

If a tax cut is indicated, the nature and magnitude of the cut could hardly coincide with the one provided by this bill. The broad base of our consumer purchasing power has not been restored since World War II, and it is this element of our economy, in the private sector, which may possibly need some stimulation. This kind of stimulation can best be brought about by raising the personal exemption. Equity, likewise, would dictate such a change.

We do have high unemployment and pockets of poverty, but the indicated corrective action must take into account specific problems and any acceptable solution must provide specific solutions. Increasing overall demand artificially through a tax cut which is poorly balanced will do little and at great cost.

Positive programs of education, and increased production in the public sector, will accomplish much, and at less cost in money. Moreover the benefits to society would be immeasurable in the long run.

Structural Changes

I. General

This bill makes a mockery of tax reform. There has been a tremendous slippage in reform from the general tenor of the remarks of administration spokesmen in 1962, to the actual proposals advanced by President Kennedy in January 1963, to the bill as approved by the Ways and Means Committee, and finally to the bill now reported from the Finance Committee.

I think it is not too extreme to say that this bill, providing as it does for enormous tax benefits for the rich and very rich through rate reduction in the upper brackets has rung the death knell for tax reform. What little reform there is in the bill, and it is miniscule when measured by obvious needs, will mark the last serious effort at reform for a generation.

Given a decent amount of time, the Senate might possibly be prevailed upon to make some significant moves toward reform. But the drumfire of propaganda and pressure for passage of this bill without quite taking the time to read it has made any serious discussion difficult if not impossible.

Under the circumstances, it is necessary to concentrate on a very few structural changes. My efforts shall be directed toward defending the public interest against special interest raids. There is so little hope of positive reform. There is such great fear of further damage.

II. The Investment Credit

As is so often the case, a tax loophole once opened is quickly widened. The crevice deepens and an apparently slight erosion of the tax base soon becomes a great gully. Often this is a process which takes a few years. In the case of the investment credit, however, the ink was hardly dry when the beneficiaries of this tax refund—a refund which must come out of the pockets of average taxpayers—began efforts to fatten themselves further.

I will not here repeat what was stated in minority views signed by Senator Paul Douglas and me when the investment credit was first adopted in 1962. For anyone who might be interested, I would cite the Report of the Committee on Finance on the Revenue Act of 1962, page 396.

Section 203 of the subject bill as reported by the Finance Committee simply makes the investment credit twice as bad as it was when it was enacted. The credit now becomes an outright gift, with not even the pretense of partial recovery through slightly decreased depreciation allowances.

There is one additional provision in this section, however, which does not even relate to revenues, and therefore has no place in this bill, but which is conducive of untold mischief. I refer to section 203(e), which would direct the Federal regulatory agencies not to order any of the benefits of the investment credit "flowed through" to consumers.

Regulatory agencies have two basic choices in handling the treatment of the tax refunds represented by the investment credit.

One method is to "flow through" the tax cut, that is, put the tax savings into the net profit figure, where it would, of course, operate to raise the utility's rate of return. It does so operate, even if the company and the regulatory agency agree to allow it to be hidden somewhere else in the books—or to pretend it does not exist, that all apparent taxes were actually paid. But if logic, equity, and decency prevail, this tax savings will be shown as a reduction of costs, or an increase in profits, and the consumer, the customer of the utility, will eventually benefit through reduced rates.

The other choice, and the one which would in effect be ordered by this bill, is to "normalize" the tax savings, that is, to permit the utility to use this tax refund as it sees fit, while continuing to charge its customers the full price it would be allowed to charge if these taxes were, in fact, actually paid.

I think it is not putting the matter too strongly to say that the Congress is, with the passage of this bill with this section intact, ordering the regulatory agencies to participate in the perpetration of a fraud on the consumers of electricity, gas, and other goods and services which come to them from these favored companies which have been given monopolies, and against whom the consumer has no recourse—there is no competitive choice available to him.

On January 23, 1964, the Federal Power Commission announced its decision in favor of "flow through." Other Federal regulatory agencies are reluctant and indecisive, and are dawdling in the hope the Congress will prohibit them from performing their duty. They have been standing by since the investment credit was enacted in 1962.

But even industry spokesmen have, in some instances, spoken out against this unconscionable theft from their customers.

Mr. Donald C. Cook, president of American Electric Power Co., Inc., in a letter to the chairman of the Finance Committee, a copy of which was very kindly sent to me, and I am sure to all members of the committee, by Mr. Cook, has set out his views on this subject.

Here is a paragraph from Mr. Cook's letter:

> It is my view that the investment credit does in fact represent a reduction in current Federal income tax expense, and therefore a reduction in current operating expenses; that the investment credit will stimulate capital expenditures by utilities even if all or part of the tax saving is passed on to customers, or if the tax saving forestalls or reduces an otherwise necessary increase in rates; and, indeed, that the use of this tax saving to reduce or avoid an increase in the price of the taxpayer's product is best calculated to increase demand and in turn to stimulate plant investment, and thus to carry out the basic objectives underlying the adoption of the credit.

Mr. Cook went on to say that he understood that his views were shared by many other utility companies and regulatory agencies.

The question of equity and forced, if not false, bookkeeping aside, there are tremendous sums of money involved. By the passage of this section, the Congress is taking away from consumers some $300 million per year by forcing higher rates on the customers of natural gas pipelines and electric utilities under the jurisdiction of the Federal Power Commission alone, considering both their interstate and intrastate business. And this is just one segment of regulated activities.

If the matter would stop with the handling of the investment credit, the situation would be bad enough. But already proposals have been advanced to have the Congress order the Federal regulatory agencies to allow regulated monopolies to "normalize" with respect to other funds.

During the Korean war, rapid amortization certificates were issued to many companies. In the 1954 Code, accelerated depreciation was approved. As a consequence, the sums of money collected from consumers by the monopolies operating in the utility field—supposedly regulated—are truly astronomical.

Amendment No. 350 to this bill has already been offered and may well be brought up during floor debate. This amendment would order the Federal regulatory agencies to give the same treatment this bill accords the investment credit to amounts set aside under liberalized depreciation provisions.

Accumulated deferred taxes of companies under the jurisdistion of the Federal Power Commission amounted to some $2 billion at the end of 1962.

These amounts, set aside under provisions of section 167 and 168 of the code, have given rise to sizable tax-free dividends. With the enactment of the principle enunciated in this bill, section 203(e), consumers will be denied the benefit of past rate reductions. They will continue to pay rates based on phantom, nonexistent taxes which show on the books, but which are never, in actuality, paid.

III. CAPITAL GAINS TREATMENT

In one major respect, the Finance Committee has improved the bill. The committee decided to delete the provision in the House-passed version of this measure which provided for an inclusion factor of only 40 percent (50 percent under present law) and a maximum rate of 21 percent (25 percent under present law) for capital gains on assets held for 2 years or longer.

It is in the capital gains area that muchof the tax dodging takes place, and this action on the part of the committee is highly commendable. At least, it is commendable in that the committee did not make a sorry situation sadder. The committee did not, of course, go so far as to make any real improvement in existing law. Holding the line, however, is a noteworthy accomplishment.

It has become customary to reduce effective tax rates by allowing many transactions which are not logically capital transactions to be so classified. One often hears of a highly compensated executive "running his money through" oil or timber or cattle. Hopefully the time will come when some real progress can be made toward correcting the many abuses associated with capital gains. In the

meantime, it is important that things not be made even more unwholesome by reducing capital gains rates.

It is through the capital gains route that the rich and very rich are often able to reduce their effective tax rates. In this connection, the table prepared by the Treasury and which appears on page 2606 of the Finance Committee hearings, is most revealing.

This table shows that, under existing law, a taxpayer with adjusted gross income of $700,000 may pay an effective tax rate which will vary from 20.1 percent to 47.6 percent, according to whether he has a high or low proportion of capital gains in his income. Under the House bill, of course, the situation is worse, his rates varying from 18.1 to 39.9 percent.

What ever happened to the 91 percent, so-called "confiscatory" tax rate?

This table also shows that the taxpayer with adjusted gross income of $2 million might pay a rate as high as 46 percent if he has little capital gains, or as low as 18.5 percent if he has a lot of capital gains, under terms of the bill.

Incidentally, although the Treasury elsewhere has tried to show that the rich and very rich gain little from the bill's rate reductions for ordinary income, this table shows that this $2 million man with little capital gains keeps a full 10 percentage points more after taxes under the bill, and would have his effective rate cut from 56.7 percent under existing law to 46 percent under the House bill. This is a pretty good measure of the benefits he receives from the rate reduction part of this bill—upward of $200,000.

IV. STOCK OPTIONS

So much has been said by me and others on the evils of the restricted stock option that it would serve no useful purpose to repeat it here. I would call attention, for those who might be interested, to remarks which I made on the Senate floor during 1961, specifically on April 14, April 24, April 27, May 4, June 8, and August 8. The hearings held by the Finance Committee on this subject on July 20 and 21, 1961, also contain useful information, as do the hearings on the subject bill.

There are some basic objections to the restricted stock option.

First, it is a device which enables corporate insiders to take money from the corporation which rightfully belongs to the stockholders.

Second, it is another of the many gimmicks associated with capital gains by which ordinary income, in this case compensation, is treated as a capital gain for income tax purposes.

Third, it encourages manipulation on the part of corporate insiders which will work harm, in varying degrees, to the whole economy, and specifically to the securities markets.

The recently publicized Chrysler Corp. incident involving options is a good case in point, and I commend to my colleagues as interesting reading the report prepared by the Treasury for the Finance Committee on this maneuver.

The subject bill makes some improvement in the option area. It will, if enacted into law, cure some abuses. It will not cure all abuses, however, and I shall renew my efforts to remove from the bill the new "qualified" stock option which replaces the old section 421 type of "restricted" stock option.

ALBERT GORE.

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Table of Contents of Senate Report No. 830, Part 2

[Supplemental Report]

TITLE III—OPTIONAL TAX ON INDIVIDUALS; COLLECTION OF INCOME TAX AT SOURCE ON WAGES

[H.R. 8363][1]

REVENUE ACT OF 1964

[Senate Report No. 830, Part 2, Eighty-eighth Congress, Second Session, Calendar No. 805]

[January 31, 1964]

Mr. LONG of Louisiana, from the Committee on Finance, submitted the following

SUPPLEMENTAL REPORT

[To accompany H.R. 8363]

TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(*a*) *Short title.*—Subsection (a) of section 1 of the bill (sec. 2 of the bill as passed by the House) provides that the bill may be cited as the "Revenue Act of 1964."

(*b*) *Amendment of 1954 Code.*—Subsection (b) of section 1 of the bill provides that whenever in the bill an amendment or repeal is expressed in terms of an amendment to or repeal of a section or other provision, the reference is considered to be made to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—REDUCTION OF INCOME TAX RATES AND RELATED AMENDMENTS

PART I—INDIVIDUALS

SECTION 111. REDUCTION OF TAX ON INDIVIDUALS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 257 of the report of the Committee on Ways and Means on the bill (H. Rept. 749, 88th Cong., 1st sess.).

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[1] Public Law 88–272, page 6, this Bulletin.

SECTION 112. MINIMUM STANDARD DEDUCTION

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 258 of the report of the Committee on Ways and Means on the bill.

SECTION 113. RELATED AMENDMENTS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 260 of the report of the Committee on Ways and Means on the bill.

SECTION 114. CROSS REFERENCES TO TAX TABLES, ETC.

Section 114 of the bill contains cross references to the provisions of the bill relating to optional tax if adjusted gross income is less than $5,000 (sec. 301) and income tax collected at source (sec. 302).

Part II—Corporations

SECTION 121. REDUCTION OF TAX ON CORPORATIONS

Your committee has approved this section except for a technical clarifying change discussed below.

Section 121 of the bill amends section 11 of the code (relating to tax on corporations). Under the bill as passed by the House, subsection (d) of section 11 of the code provided that for purposes of subtitle A of the code (relating to income tax) the surtax exemption for any taxable year was to be $25,000 or the amount determined under section 1561 of the code (relating to surtax exemptions in case of certain controlled corporations), as added by section 237 of the bill (section 223 of the bill as passed by the House). Your committee has made a clarifying amendment, and as amended subsection (d) of section 11 provides that for purposes of subtitle A the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 applies, the surtax exemption is the amount determined under such section.

For the technical explanation of this section of the bill, see page 260 of the report of the Committee on Ways and Means on the bill.

SECTION 122. CURRENT TAX PAYMENTS BY CORPORATIONS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 261 of the report of the Committee on Ways and Means on the bill.

SECTION 123. RELATED AMENDMENTS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 264 of the report of the Committee on Ways and Means on the bill.

PART III—EFFECTIVE DATES

SECTION 131. GENERAL RULE

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 265 of the report of the Committee on Ways and Means on the bill.

SECTION 132. FISCAL YEAR TAXPAYERS

Except for conforming changes referring to the "Revenue Act of 1964" (instead of the "Revenue Act of 1963"), this section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 265 of the report of the Committee on Ways and Means on the bill.

TITLE II—STRUCTURAL CHANGES

SECTION 201. DIVIDENDS RECEIVED BY INDIVIDUALS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 268 of the report of the Committee on Ways and Means on the bill.

SECTION 202. LIMITATION ON RETIREMENT INCOME

Section 202 of the bill, which is a new section added to the bill as passed by the House, amends section 37 of the code by inserting a new subsection (i) therein. Section 37 relates to the retirement income credit.

Under existing law eligible taxpayers 65 or over who receive taxable pensions or annuities, interest, rents, dividends, etc., and eligible taxpayers, regardless of age, who receive taxable pensions or annuities under public retirement systems (as defined in section 37(f)), are allowed a retirement income credit. To be eligible for the retirement income credit, a taxpayer must have received in each of any 10 calendar years before the taxable year earned income (as defined in section 37(g)) in excess of $600. The amendments made by section 202 of the bill make no change in existing law with respect to the foregoing.

Under existing law, the retirement income credit is computed by multiplying the amount of retirement income, limited to a maximum of $1,524, by the rate of tax on the first $2,000 of taxable income. The amendments made by your committee increase the limitation on retirement income under certain circumstances and are discussed below. Also under subsection (a) of section 113 of the bill, the rate against which retirement income (as defined in subsection (c) and as limited by subsection (d) of section 37) is to be multiplied for purposes of computing the retirement income credit is established as 15 percent.

Under existing law, the maximum retirement income of an individual on which the credit may be based ($1,524) is reduced by amounts received as a pension or annuity either under title II of the Social Security Act or under the Railroad Retirement Act of 1935 or 1937, and by amounts received from other pensions or annuities which

are exempt from tax. In the case of an individual who has attained the age of 62 but who has not attained the age of 72 before the close of the taxable year, the maximum retirement income on which credit may be based is also reduced by the sum of one-half the amount of earned income received during the taxable year in excess of $1,200 but not in excess of $1,700 and the amount of earned income in excess of $1,700. In the case of an individual who has not attained the age of 62 before the close of the taxable year, the maximum retirement income is reduced by the amount of earned income received during the taxable year in excess of $900.

Under existing law, the retirement income credit is computed separately for each spouse and each spouse is required to meet the earned income test in section 37(b) ($600 of earned income in each of any 10 prior years); except that in the case of a widow or widower whose spouse had received such earned income, such widow or widower is considered to have received earned income.

Subsection (a) of section 202 of the bill adds a new subsection (i) to section 37 of the code. The new subsection (i) provides for an increase, in certain cases, in the limitation on retirement income in the case of married taxpayers both of whom have attained the age of 65 before the close of the taxable year and who file a joint return for the taxable year.

Paragraph (1) of new section 37(i) provides that if both spouses meet the earned income test in subsection (b) of section 37 and if the sum of the retirement income and the amounts described in paragraphs (1) and (2) of subsection (d) of such section received by either spouse during the taxable year is less than $762, the $1,524 amount referred to in subsection (d) shall, with respect to the other spouse, be increased by an amount equal to the amount by which such sum is less than $762. If such sum is equal to or greater than $762, no such adjustment shall be made. The application of the provisions of paragraph (1) of new section 37(i) may be illustrated by the following example:

Example 1.—H and W, each of whom are 66 years of age and each of whom meets the earned income test in section 37(b), file a joint return for the calendar year 1964. During 1964, H receives as his only income $8,000 of retirement income and no social security benefits or other amounts described in paragraph (1) of section 37(d). During 1964, W receives as her only income $100 of retirement income and $500 under title II of the Social Security Act.

Under existing law, H is entitled to a retirement income credit computed on the maximum retirement income of $1,524. W is entitled to a retirement income credit computed on $100 of retirement income.

Under the new section (i), the $1,524 limitation on the retirement income of H would be increased by $162. The $162 increase is computed under paragraph (1) of new subsection (i) by subtracting from $762 the sum of the retirement income received by W ($100) and the social security benefits received by W ($500). The retirement income credit of W is not affected.

Paragraph (2) of new section 37(i) provides that if either spouse does not meet the earned income test in subsection (b) of section 37, the $1,524 amount referred to in subsection (d) of such section shall, with respect to the other spouse, be increased by $762 minus the sum of the amounts described in paragraphs (1) and (2) of subsection (d) received by the spouse who did not meet the earned income test.

The application of the provisions of paragraph (2) of new section (i) may be illustrated by the following example:

Example 2.—Assume the same facts as in example 1 above except that W does not meet the earned income test in section 37(b). Under existing law, H is entitled to a retirement income credit computed on the maximum retirement income of $1,524. (W is not entitled to any retirement income credit.)

Under the new section 37(i), the $1,524 limitation on the retirement income of H would be increased by $262. The $262 increase is computed under paragraph (2) of new subsection (i) by subtracting from $762 the social security benefits received by W ($500).

Subsection (b) of section 202 of the bill provides that the amendments made by section 202 of the bill apply to taxable years beginning after December 31, 1963.

SECTION 203. REPEAL OF REQUIREMENT THAT BASIS OF SECTION 38 PROPERTY BE REDUCED BY 7 PERCENT; OTHER PROVISIONS RELATING TO INVESTMENT CREDIT

Your committee has approved subsection (a) of section 203 of the bill (section 202(a) of the bill as passed by the House) with changes in the effective dates (discussed below); and has approved subsections (b) through (f) without change. For the technical explanation of subsections (b) through (f) of section 203 (sec. 202 of the bill as passed by the House) of the bill, see page 273 of the report of the Committee on Ways and Means on the bill.

(*a*) *Repeal of requirement that basis be reduced.*—Subsection (a) of section 203 of the bill repeals section 48(g) of the code, which relates to adjustments to basis of section 38 property (that is, property with respect to which an investment credit is allowable), with respect to such property placed in service after December 31, 1963. In the case of property placed in service before January 1, 1964, subsection (a) of section 203 of the bill repeals section 48(g) with respect to taxable years beginning after December 31, 1963, and provides for an increase in basis as of the first day of the taxpayer's first taxable year which begins after December 31, 1963. Subsection (a) of section 203 also makes certain related amendments to the code.

Repeal of reduction in basis under section 48(g)(1)

Paragraph (1) of section 203(a) of the bill repeals paragraph (1) of section 48(g) of the code. (See below for discussion of repeal of paragraph (2) of sec. 48(g).) Under paragraph (1) of section 48(g), the basis of any section 38 property is reduced by an amount equal to 7 percent of the qualified investment (as determined under sec. 46(c)) with respect to such property. This reduction in basis is taken into account for purposes of subtitle A of the code, relating to income tax, except for purposes of computing, or recomputing, the investment credit. Thus, the reduction in basis is taken into account for purposes of computing depreciation deductions and for purposes of computing gain or loss on the sale or other disposition of the property.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31,

1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus, a taxpayer who makes his return on the basis of a fiscal year ending March 31, must reduce the basis of any section 38 property placed in service before January 1, 1964, but is not required to reduce the basis of any section 38 property placed in service after December 31, 1963. No reduction in basis is to be made in the case of section 38 property the construction, reconstruction, or erection of which is completed, or which is acquired, before January 1, 1964, but which is placed in service after December 31, 1963.

Repeal of increase in basis under section 48(g)(2)

Paragraph (1) of section 203(a) of the bill also repeals paragraph (2) of section 48(g) of the code. Under paragraph (2) of section 48(g), if the tax under chapter 1 of the code is increased for any taxable year under paragraph (1) or (2) of section 47(a) of the code (relating to certain dispositions, etc., of sec. 38 property) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in such paragraph (1) or (2) of section 47(a) is increased by an amount equal to the portion of such increase in tax, or the portion of such adjustment to carrybacks or carryovers, attributable to such property. The increase in basis is made immediately before the event which causes paragraph (1) or (2) of section 47(a) to apply. Thus, the increase in basis is taken into account for purposes of determining gain or loss on a disposition of the property.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus if, in February 1964, section 47(a) (1) or (2) applies to increase the tax of a taxpayer who makes his return on the basis of a fiscal year ending March 31, under chapter 1 of the code with respect to property placed in service in 1962, the basis of such property is increased under section 48(g)(2) by the amount of such increase in tax.

Increase in basis of property on account of prior reduction

Paragraph (2)(A) of section 203(a) of the bill provides, in general, that the basis of any section 38 property (as defined in sec. 48(a) of the code) placed in service before January 1, 1964, is to be increased, under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property. In determining the amount of such increase in basis, any prior increase in basis with respect to the property under section 48(g)(2) (in taxable years beginning before Jan. 1, 1964) is to be taken into account. Thus, the amount of the increase in basis under paragraph (2)(A) of section 203(a) of the bill is equal to the amount of the reduction in basis under section 48(g)(1) less any increase in basis under section 48(g)(2) with respect to such property. The basis of any section 38 property is not increased under paragraph (2)(A) of section 203(a) of the bill if the taxpayer dies in a taxable year beginning before January 1, 1964.

The increase in basis provided by paragraph (2)(A) of section 203(a) of the bill is to be made, under paragraph (2)(C) of section 203(a), as of the first day of the first taxable year of the taxpayer which begins after December 31, 1963. Generally, such increase in basis is to be taken into account by the person whose basis of the property was reduced under section 48(g)(1). Thus, in the case of partnership section 38 property, the increase in basis is to be taken into account by the partnership as of the first day of its first taxable year which begins after December 31, 1963. If a transaction to which section 381(a) of the code applies or a mere change in the form of conducting a trade or business (within the meaning of sec. 47(b) of the code) occurs before the increase in basis has been taken into account by the transferor, the increase in basis is taken into account by the transferee. For example, if calendar-year individual A, who placed section 38 property in service before January 1, 1964, transfers the section 38 property to calendar-year corporation X on September 1, 1963, in a transaction to which section 47(a) does not apply because such transaction constitutes a mere change in the form of conducting the trade or business, the increase in basis is to be taken into account by corporation X as of January 1, 1964.

The increase in basis is to be taken into account for purposes of computing depreciation deductions for the taxpayer's first taxable year which begins after December 31, 1963, and for all subsequent periods, and for purposes of computing gain or loss on the sale or other disposition of the property.

The provisions of paragraph (2)(A) of section 203(a) of the bill are illustrated by the following example:

Example.—X corporation, which makes its returns on the basis of the calendar year, acquires and places in service on January 1, 1962, an item of new section 38 property with a basis of $10,000 and an estimated useful life of 10 years. For the taxable year 1962, X is allowed a credit of $700 (7 percent of $10,000). Under section 48(g)(1) of the code, the basis of the property is reduced by $700. Under paragraph (2)(A) of section 203(a) of the bill, the basis of the property is increased on January 1, 1964, by $700 (7 percent of $10,000, the qualified investment). However, if such property had been sold by X on December 1, 1963, on such date the basis of such property is increased under section 48(g)(2) by $700, and there would be no further increase on January 1, 1964. If X was a partnership and if a partner had disposed of his partnership interest on December 1, 1963, and on such date the basis of such property had been increased under section 48(g)(2) by $500, the basis of the property would be increased on January 1, 1964, by only $200 ($700 minus $500). If X was an individual who died on December 1, 1963, there would be no increase under section 203(a)(2)(A) of the bill in the basis of such property.

Increase in rental deductions

Paragraph (2)(B) of section 203(a) of the bill provides that if, with respect to any section 38 property placed in service before January 1, 1964, a lessor made the election (provided by sec. 48(d) of the code) to treat the lessee as having purchased such property for purposes of the investment credit, the basis of such property is not to be increased under paragraph (2)(A) of section 203(a) of the bill. However, under regulations prescribed by the Secretary of

the Treasury or his delegate, the deductions otherwise allowable under section 162 of the code to the lessee with respect to such property for amounts paid to the lessor under the lease (hereinafter referred to as rental deductions) are to be adjusted in a manner consistent with paragraph (2)(A). The amount of the increase in rental deductions with respect to a leased property placed in service before January 1, 1964, may not exceed the sum of the actual decreases made (under the last sentence of sec. 48(d)) in the rental deductions with respect to such property. In determining the amount of the increase in such rental deductions, any prior increase in such deductions under the last sentence of section 48(d) because of the application of section 47(a) (in taxable years beginning before Jan. 1, 1964) is to be taken into account. The rental deductions with respect to any section 38 property are not to be increased under paragraph (2)(B) of section 203 (a) of the bill if the lessee dies in a taxable year beginning before January 1, 1964.

The amount of the increase in rental deductions with respect to a leased property is to be taken into account, commencing with the first taxable year beginning after December 31, 1963, over the remaining portion of the useful life used in making the decreases in rental deductions with respect to such property. Generally, if the lessee terminates the lease during this period, the portion of the increase which has not yet been taken into account is allowed as a deduction in the taxable year in which such termination occurs. If the lessee actually purchases the leased property during this period, the portion of the increase which has not yet been taken into account is added to the basis of the property at the date of purchase.

If a lessor of property makes the election under section 48(d) to treat the lessee as having purchased section 38 property for purposes of the investment credit and if such lessee in a taxable year beginning before January 1, 1964, actually purchases such property, the basis of such property is increased by 7 percent of the qualified investment with respect to such property (in a manner consistent with par. (2)(A) of sec. 203(a) of the bill) as of the first day of the first taxable year beginning after December 31, 1963.

The provisions of paragraph (2)(B) of section 203(a) of the bill are illustrated by the following example:

Example.—X corporation constructs a machine after December 31, 1961, and on February 1, 1962, leases the machine to Y, a calendar year taxpayer, who places it in service. The fair market value of the machine on the date on which possession is transferred to Y is $25,200 and the machine has an estimated useful life to X of 12 years. X elects to treat Y as the purchaser of the property for purposes of the investment credit. For purposes of computing qualified investment under section 46(c) of the code, the basis of the property to Y is $25,200 and Y's credit earned for 1962 with respect to such machine is $1,764 (7 percent of $25,200). Y's rental deductions with respect to such machine are decreased by $12.25 each month ($1,764 divided by 144 months). Under paragraph (2)(B) of section 203(a) of the bill, Y's rental deductions are increased by $281.75 ($12.25 multiplied by 23 months). Such increase is taken into account over the remaining 121 months of the useful life of the machine commencing with the taxable year 1964. If Y had actually purchased the machine from X on January 1, 1963, and had reduced the basis of the machine on such date by $1,629.25

($1,764 minus $134.75), the basis of such machine in Y's hands would be increased, on January 1, 1964, by $1,764 (7 percent of the qualified investment).

Certain leased property

Paragraph (3)(A) of section 203(a) of the bill repeals the last sentence of section 48(d) of the code. Under the last sentence of section 48(d), if a lessor makes an election to treat the lessee of section 38 property as having acquired such property for purposes of the investment credit, section 48(g) (relating to adjustments to basis) does not apply with respect to such property and the deductions otherwise allowable to the lessee under section 162 of the code for amounts paid to the lessor under the lease must be adjusted in a manner consistent with the provisions of section 48(g).

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus, if lessor X elects to treat calendar year lessee Y, who placed section 38 property in service in July 1962, as the purchaser of the property for purposes of the investment credit, Y reduces his deductions for rental payments under section 162 of the code for his 1962 and 1963 taxable years, but does not reduce his rental deductions for any subsequent taxable year. If in December 1963 section 47(a) (1) or (2) of the code applies to increase Y's tax with respect to such property, Y's rental deductions with respect thereto are adjusted, under the last sentence of section 48(d), in a manner consistent with section 48(g)(2). However, if Y had placed the property in service on January 1, 1964, Y would not reduce or otherwise adjust his deductions for rental payments for any taxable year.

Deduction for certain unused investment credit

Paragraph (3)(B) of section 203(a) of the bill repeals section 181 of the code. Under section 181, if the amount of the credit earned for any taxable year exceeds the limitation provided by section 46(a)(2) (relating to limitation based on amount of tax) for such year and if any portion of such excess is not allowed as a credit after the application of the 3-year carryback and the 5-year carryover provisions, then the portion of such excess not so allowed as a credit in any of such taxable years is allowed to the taxpayer as a deduction in the sixth taxable year following the taxable year in which the credit was earned. Section 181 further provides that if a taxpayer dies or ceases to exist prior to such sixth taxable year, such taxpayer is allowed as a deduction, for the taxable year of such death or cessation, an amount equal to the proper portion of such excess.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963.

Adjustments to basis under section 1016

Paragraph (3)(C) of section 203(a) of the bill makes a technical amendment to section 1016(a)(19) of the code (relating to adjustments to basis).

Clerical amendment

Paragraph (3)(D) of section 203(a) of the bill amends the table of sections for part VI of subchapter B of chapter 1 of the code.

Effective date

Paragraph (4) of section 203(a) of the bill provides effective dates for the amendments made by paragraphs (1) and (3) of section 203(a). Paragraph (4)(A) provides that if the property involved is placed in service after December 31, 1963; then the amendments made by paragraphs (1) and (3) apply with respect to taxable years ending after December 31, 1963. Paragraph (4)(B) provides that if the property is placed in service before January 1, 1964, then the amendments made by paragraphs (1) and (3) apply with respect to taxable years beginning after December 31, 1963.

SECTION 204. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *Inclusion in income.*—Subsection (a)(1) of section 204 of the bill (sec. 203 of the bill as passed by the House) adds a new section 79 to part II of subchapter B of chapter 1 of the code (relating to items specifically included in gross income).

SECTION 79. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *General rule.*—The new section 79(a) has been approved by your committee with one change. In the bill as passed by the House, an exclusion was provided for the cost of the first $30,000 of group-term life insurance provided for an employee. Your committee has increased such exclusion to the cost of the first $70,000 of such insurance. For the technical explanation of the new section 79(a) of the code (other than the amendment made by your committee), see page 277 of the report of the Committee on Ways and Means on the bill.

(*b*) *Exceptions.*—The new section 79(b) has been approved by your committee without change. For a technical explanation of this section, see page 279 of the report of the Committee on Ways and Means on the bill.

(*c*) *Determination of cost of insurance.*—The new section 79(c) as passed by the House provides rules for determining the cost of group-term life insurance protection with respect to an employee. Your committee has modified this section to eliminate one of the two alternative methods of determining cost. As passed by the House, section 79(c) contains three paragraphs, paragraph (1), (2), and (3). Your committee has deleted paragraph (2) and has combined without substantive change the provisions contained in paragraphs (1) and (3) into section 79(c).

Uniform premium table method

Under the bill as passed by the House, paragraph (1) of section 79(c) provides that the cost of group-term life insurance protection on the life of an employee provided during any period is determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) to be set forth in a table prescribed in regulations by the Secretary of the Treasury or his delegate. Your committee has made

this method the sole method of determining the cost of group-term life insurance with respect to any employee. Under the bill as amended by your committee, this method of determining cost is now set forth in the first sentence of the new section 79(c).

Policy cost method

Under the bill as passed by the House, paragraph (2) of section 79(c) provides that, in lieu of using the uniform premium table, the employer may elect, with respect to any employee, to determine the cost of such employee's group-term life insurance on the basis of the average premium cost under the policy for the ages included within the age bracket which is applicable to the employee under the provisions of paragraph (1). Your committee has deleted this provision from the bill.

Employed individuals over age 64

Under the bill as passed by the House, paragraph (3) of section 79(c) provides that in the case of an employee who has attained age 64, the prescribed cost cannot exceed the cost with respect to the individual if he were age 63. Under the bill as amended by your committee this provision is incorporated in the second sentence of the new section 79(c).

Example.—The operation of the new section 79 as amended by your committee may be illustrated by the following example. Assume that for a full taxable year an employee, age 52, is provided (under a policy carried by his employer) with $110,000 of group-term life insurance on his life and that his spouse is the beneficiary. Assume further that the uniform premium applicable at his age is $10.87 per $1,000 of protection and that the employee contributes $1 per $1,000 of protection. Based on these facts, the amount includible in the employee's income is computed as follows:

Total group-term life insurance protection	$110, 000
Less $70,000 exclusion	70, 000
	40, 000
Cost of $40,000 of insurance (40×$10.87)	434. 80
Less employee's contributions (110×$1)	110. 00
Amount includible in employee's gross income	324. 80

SECTION 204. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES—Continued

Full-time life insurance salesmen

Subsection (a)(3) of section 204 of the bill amends section 7701(a)(20) of the code to provide that a full-time life insurance salesman who is considered an employee for purposes of chapter 21 of the code shall also be considered an employee for purposes of the new section 79. This subsection has been approved by your committee with a clerical change.

Certain contributions by employees for group-term life insurance

Subsection (b) of section 203 of the bill as passed by the House added a new section 218 to part VII of subchapter B of chapter 1 of the code (relating to additional itemized deductions for individuals). Your committee has deleted this subsection from the bill.

(*b*) *Withholding.*—Subsection (b) of section 204 of the bill (subsec. (c) of sec. 203 of the bill as passed by the House) amends section 3401(a) of the code (relating to definition of wages) by adding a new paragraph (14) at the end thereof. Under this new paragraph (14), as passed by the House, the term "wages" (for purposes of withholding of income tax at source on wages) includes remuneration paid in the form of group-term life insurance on the life of an employee, but only to the extent that the cost of such insurance is includible in the employee's gross income under the provisions of section 79(a) of the code (added to the code by this section of the bill). Your committee has amended the new paragraph (14) to provide that the term "wages" (for purposes of withholding of income tax at source on wages) does not include remuneration paid in the form of group-term life insurance on the life of an employee. In lieu of the deleted withholding provision, your committee has provided an information reporting requirement.

(*c*) *Information reporting.*—Subsection (c)(1) of section 204 of the bill adds a new section 6052 to subpart C of part III of subchapter A of chapter 61 of the code (relating to information concerning transactions with other persons).

The new section 6052(a) provides that every employer who, during any calendar year, provides group-term life insurance on the life of an employee during part or all of such calendar year under a policy (or policies) carried directly or indirectly by such employer shall make a return according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate setting forth the cost of such insurance and the name and address of the employee on whose life such insurance is provided, but only to the extent that the cost of such insurance is includible in the employee's gross income under section 79(a). For purposes of the new section 6052(a), the cost of group-term life insurance is determined with reference to the cost of the life insurance (computed as provided in sec. 79(c)) provided to the employee, without regard to the time when the premium is paid by the employer. Under the provisions of the new section 6052(a), each employer paying remuneration to an employee in the form of group-term life insurance determines the amount includible in such employee's gross income under section 79(a) of the code as if such employer were the only employer paying the employee remuneration in the form of such insurance. Thus, an employer computes the amount includible in the gross income of an employee by applying a full $70,000 exclusion, without regard to whether another employer may also be furnishing group-term life insurance for the same employee during the same period.

The new section 6052(b) provides that every employer making a return under subsection (a) is to furnish to each employee whose name is set forth in such return a written statement showing the cost of the group-term life insurance shown on such return. The written statement required under the preceding sentence is to be furnished to the employee on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

Your committee has also provided that the penalties imposed by section 6652(a) of the code (relating to penalty for failure to file certain information returns) and section 6678 of the code (relating to penalty for failure to furnish certain statements) are to apply in the

case of each failure to file, with respect to an employee, a return or statement required by the new section 6052. See paragraph (2) of section 204(c), and paragraph (2) of section 222(b), of the bill.

(*d*) *Effective dates.*—Subsection (d) of section 204 of the bill provides that the amendments made by subsections (a) and (c) of this section of the bill, and paragraph (2) of section 222(b) of the bill, apply with respect to group-term life insurance provided after December 31, 1963, in taxable years ending after such date. The amendment made by subsection (b) applies with respect to remuneration paid after December 31, 1963, in the form of group-term life insurance provided after such date.

SECTION 205. AMOUNTS RECEIVED UNDER WAGE CONTINUATION PLANS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 283 of the report of the Committee on Ways and Means on the bill.

SECTION 206. EXCLUSION FROM GROSS INCOME OF GAIN ON SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 284 of the report of the Committee on Ways and Means on the bill.

SECTION 207. DENIAL OF DEDUCTION FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

Section 207 of the bill as passed by the House consisted of three subsections. Subsection (a) of such section 207 revised subsections (a), (b), and (c) of section 164 of the code (relating to deduction for taxes). Subsection (b) of such section 207 made a number of technical amendments to the code and subsection (c) thereof contained the effective date provisions.

Your committee has made changes in subsection (a) of section 207 of the bill which affect subsections (a) and (b) of section 164 of the code. Subsection (b) of section 207 of the bill, as passed by the House, has been approved by your committee without change. Your committee has changed subsection (c) of section 207 of the bill by adding a new paragraph (2) thereto.

For the technical explanation of section 207 of the bill (other than the amendments made by your committee), see page 288 of the report of the Committee on Ways and Means on the bill.

Section 164(a) as amended

Subsection (a) of section 164 of the code, as amended by the bill as passed by the House, provided, in part, that the following taxes would be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.
(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

Your committee has added to the foregoing list State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels and State and local taxes on the registration or licensing of highway motor vehicles and on licenses for the operation of highway motor vehicles. As a result of your committee's amendment, any State and local taxes within the scope of the amendment which are now deductible under section 164 remain so; any such taxes which are not presently deductible are not made deductible by such amendment.

Section 164(b) as amended

Your committee has added a new paragraph (5) to section 164(b) of the code, as amended by the bill as passed by the House, to provide a special rule in the case of separately stated general sales taxes and any tax on the sale of gasoline, diesel fuel, or other motor fuel. This provision corresponds to section 164(b)(2)(E) as passed by the House except that its scope has been broadened to apply to taxes on the sale of gasoline, diesel fuel, and other motor fuel. If a tax to which this special rule has application is imposed on the seller, but the amount of such tax is separately stated, then (as under existing law), to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount is treated as a tax imposed on, and paid by, such consumer.

Subsection (c) of section 207

Under the bill as passed by the House, paragraph (1) of section 164(c) of the code denied a deduction for taxes assessed against local benefits of a kind tending to increase the value of the property assessed, except for the portion of such taxes properly allocable to interest or maintenance charges. Such paragraph (1) retained the rules of present law now contained in paragraph (5) of section 164(b) of the code but did not retain the exception to those rules now contained in section 164(b)(5)(B) which allow the deduction of local benefit taxes levied by a special taxing district if the taxes meet the tests specified therein.

Your committee has made no change in the language of paragraph (1) of section 164(c) of the code as contained in the House bill. However, your committee has added a new paragraph (2) to section 207(c) of the bill which provides that section 164(c)(1), as amended, shall not prevent the deduction under section 164, of taxes levied by a special taxing district—

(1) which is described in section 164(b)(5) of the code (as in effect for a taxable year ending on Dec. 31, 1963), and

(2) which was in existence on December 31, 1963,

but only in the case of taxes levied for the purpose of retiring indebtedness which existed on December 31, 1963.

SECTION 208. PERSONAL CASUALTY AND THEFT LOSSES

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page 293 of the report of the Committee on Ways and Means on the bill.

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SECTION 209. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS

(*a*) *Certain organizations added to additional 10-percent charitable limitation.*—Subsection (a) of section 209 of the bill as passed by the House has been approved by your committee without change. For the technical explanation of this subsection of the bill, see page 295 of the report of the Committee on Ways and Means on the bill.

(*b*) *Limitation of unlimited charitable contribution deduction.*—Your committee has added a new subsection (b) to section 209 of the bill to provide a limitation on the existing unlimited charitable contribution deduction.

Existing law

An individual taxpayer is presently allowed an unlimited charitable contribution deduction if in the taxable year, and in 8 of the 10 preceding taxable years, the charitable contributions and income taxes paid by the taxpayer during such year exceed 90 percent of his taxable income computed without deduction for charitable contributions, personal exemptions, and net operating loss carrybacks. Under existing law, the charitable contributions which may be used to satisfy the 90-percent requirement include contributions to both publicly and privately supported organizations.

Changes made by your committee

Subsection (b) of section 209 of the bill, as reported, amends section 170(b)(1) of the code by redesignating subparagraph (D) as (E) and by inserting a new subparagraph (D). The new subparagraph provides that only contributions described in subparagraph (A) of section 170(b)(1) (i.e., contributions to those organizations to which the additional 10-percent limitation is applicable) will qualify as charitable contributions for purposes of the unlimited charitable contribution deduction provisions. In general, these organizations include churches, certain educational organizations, certain hospitals and medical research organizations, certain organizations affiliated with State colleges and universities, certain governmental units, and certain other publicly supported organizations. Thus, for taxable years begining after December 31, 1963, only contributions to such organizations shall be taken into account in determining whether the taxpayer has satisfied the 90-percent requirement of section 170(b)(1)(C) for the current taxable year and for those taxable years preceding the current taxable year which begin after December 31, 1963. Contributions not described in section 170(b)(1)(A), such as contributions to private foundations, will not qualify as charitable contributions for purposes of the unlimited charitable contribution deduction provisions.

The new section 170(b)(1)(D) also provides that for purposes of section 170(b)(1)(C), the amount of charitable contributions shall be determined without regard to new paragraph (5) of section 170(b) of the code (added by sec. 209(c) of the bill, as reported). Therefore, in determining whether a taxpayer has satisfied the 90-percent requirement of subparagraph (C) for a current taxable year which begins after December 31, 1963, and for those taxable years preceding the current taxable year which begin after December 31, 1963, contributions made in prior years, but which under the provisions of

new paragraph (5) are treated as having been paid in subsequent years, shall not be taken into account.

The new section 170(b)(1)(D) provides that section 170(b)(1)(C) shall apply only if the taxpayer so elects. Such election can only be made by those taxpayers who satisfy the requirements of section 170(b)(1)(C), as modified by new section 170(b)(1)(D). The time and manner of such election shall be prescribed under regulations promulgated by the Secretary of the Treasury or his delegate. If a taxpayer makes such election, subsection (a) of section 170 shall apply only with respect to contributions described in subparagraph (A) of section 170(b)(1). Thus, a taxpayer who elects to apply section 170(b)(1)(C) and thus to deduct contributions to a publicly supported charitable organization in excess of the generally applicable 30-percent limitation may not also deduct contributions which he makes to private foundations. In addition, the new section 170(b)(1)(D) provides that if a taxpayer elects to apply section 170(b)(1)(C), contributions made in the current taxable year, or in any prior taxable year, may not be treated under new paragraph (5) of section 170(b) of the code as having been made in the current taxable year or in any succeeding taxable year.

Effective date

New section 170(b)(1)(D) shall apply with respect to contributions which are paid in taxable years beginning after December 31, 1963.

(c) *Five-year carryover of certain charitable contributions made by individuals.*—Subsection (c) of section 209 of the bill, as reported, adds a new paragraph (5) to section 170(b) of the code (relating to limitations on charitable contribution deduction) to provide a carryover of certain excess contributions made by individuals.

Subparagraph (A) of new section 170(b)(5) provides, in general, that in the case of an individual, if the amount of charitable contributions described in paragraph (1)(A) of section 170(b) (relating to contributions to churches, certain educational organizations, certain hospitals and medical research organizations, certain organizations affiliated with State colleges or universities, certain governmental units, and certain other publicly supported organizations), payment of which is made within a taxable year, exceeds 30 percent of the taxpayer's adjusted gross income for such year (computed without regard to any net operating loss carryback to such year under section 172), such excess shall be treated as a charitable contribution described in paragraph (1)(A) paid in each of the 5 succeeding taxable years in order of time. However, with respect to any such succeeding taxable year, the amount which is to be treated as paid in such succeeding taxable year is limited to the extent of the lesser of two amounts: (*i*) the amount by which 30 percent of the taxpayer's adjusted gross income for such succeeding taxable year (computed without regard to any net operating loss carryback to such succeeding taxable year under section 172) exceeds the sum of the charitable contributions described in paragraph (1)(A) payment of which is made by the taxpayer within such succeeding taxable year (determined without regard to new paragraph (5)) and the charitable contributions described in paragraph (1)(A) payment of which was made in taxable years before the contribution year which are treated under this new rule as having been paid in such succeeding taxable year; or (*ii*) in the case of the first succeeding taxable year, the amount of such excess contribution, and in the

case of the second, third, fourth, or fifth succeeding taxable year, the portion of such excess not treated under new paragraph (5) as a charitable contribution described in paragraph (1)(A) paid in any taxable year intervening between the contribution year and such succeeding taxable year.

Under the provisions of new paragraph (5), no excess contribution carryover will be allowed with respect to contributions to organizations not described in subparagraph (A) of section 170(b)(1), such as private foundations.

The new paragraph (5) of section 170(b) does not apply with respect to estates or trusts.

The application of new paragraph (5) is illustrated by the following examples:

Example 1.—Taxpayer A has adjusted gross income for 1964 of $50,000. In 1964 A contributes $16,500 to a church and $1,000 to a private foundation. Under existing law, A could claim a charitable contribution deduction of $15,000 (30 percent of $50,000). Under the bill, as approved by your committee, A could claim a charitable contribution deduction of $15,000 in 1964 and would have a charitable contribution carryover of $1,500 (excess of $16,500 contribution to the church over 30 percent of adjusted gross income of $50,000) to succeeding taxable years. No carryover would be allowed with respect to the $1,000 contribution to the private foundation.

Example 2.—Assume the same facts as in example 1. Assume further that for 1965 A has adjusted gross income of $40,000, and in 1965 contributes $11,000 to a church and $400 to a private foundation. Under existing law, A could claim a charitable contribution deduction of $11,400. Under the bill, as approved, by your committee, $1,000 ($40,000×30 percent=$12,000−$11,000 contribution paid to church in 1965) of the $1,500 excess contribution to the church which was paid in 1964 would be treated as paid in 1965 and therefore A could claim a total charitable contribution deduction of $12,000 for 1965. The remaining $500 of the excess contribution paid to the church in 1964 would be available for purposes of computing the carryover from 1964 to 1966, 1967, 1968, and 1969. No carryover would be allowed with respect to the $400 contribution to the private foundation.

Subparagraph (B) of new section 170(b)(5) provides that in the application of subparagraph (A), the excess determined under such subparagraph for the contribution year shall be reduced to the extent that such excess reduces taxable income as computed for purposes of the second sentence of section 172(b)(2) (relating to amount of net operating loss carrybacks and carryovers) and increases the net operating loss deduction for a taxable year succeeding the contribution year. To prevent a double deduction which might arise from the interrelationship of the charitable contribution carryover and the net operating loss carryover, subparagraph (B) of new section 170(b)(5) provides, in effect, that an excess charitable contribution shall reduce taxable income only once.

Paragraph (2) of section 209(c) of the bill contains technical amendments. Section 545(b)(2) (relating to deductions for charitable contributions by personal holding companies) and section 556(b)(2) (relating to deductions for charitable contributions by foreign personal holding companies) are each amended, in effect, to provide that new

paragraph (5) of section 170(b) shall not apply for purposes of computing the deduction for charitable contributions provided under section 170 with respect to these organizations.

Effective date

New paragraph (5) of section 170(b) shall apply with respect to charitable contributions which are paid in taxable years beginning after December 31, 1963.

(*d*) *Five-year carryover of certain charitable contributions made by corporations.*—Subsection (b) of section 209 of the bill as passed by the House has been redesignated as subsection (d) and, with the exception of a change made in the effective date of this subsection, has been approved by your committee without change.

Under the bill as passed by the House, the 5-year corporate carryover applied only with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the Internal Revenue Code of 1954) in taxable years beginning after December 31, 1963. Under the bill, as approved by your committee, the 5-year corporate carryover shall apply to taxable years beginning after December 31, 1963, with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the Internal Revenue Code of 1954) in taxable years beginning after December 31, 1961.

For the technical explanation of this subsection of the bill, see page 296 of the report of the Committee on Ways and Means on the bill.

(*e*) *Future interests in tangible personal property.*—Subsection (c) of section 209 of the bill as passed by the House has been redesignated as subsection (e) and has been approved by your committee with an amendment.

As passed by the House, a new subsection (f) was added to section 170 of the code. Section 170(a) of the code provides that a charitable contribution is allowable as a deduction for the taxable year during which payment thereof is made. The new section 170(f) adds a special rule to determine when a charitable contribution consisting of a future interest in tangible personal property is considered to be paid. Under the bill as reported, the new section 170(f) provides, in effect, that the gift of such an interest will be considered to be incomplete for so long as the contributor (or a person standing in a relationship to the contributor described in sec. 267(b) of the code (relating to losses, expenses, and interest with respect to transactions between related taxpayers)) retains an intervening interest or right to the actual possession or enjoyment of the property. Under this special rule, a charitable contribution of a future interest in tangible personal property is deemed paid only when (1) all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired, or (2) all intervening interests in, and rights to the actual possession or enjoyment of, the property are held by a person or persons other than the contributor or related parties.

The bill as passed by the House also contains an exception which was stated in the last two sentences of new subsection (f). Such exception provided that the special rule of section 170(f) does not apply to a contribution in which the sole intervening interest or right is a nontransferable interest reserved by the donor which expires upon the donor's death, or, in the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable interest reserved by the donors which expires upon the death of whichever of such donors

dies later. However, the right to transfer the reserved life interest to the donee of the future interest (i.e., the charity which receives the future interest contributed) was not treated as making a life estate transferable.

New subsection (f), as approved by your committee, eliminates this exception.

The application of new subsection (f), as approved by your committee, may be illustrated by the following example. If a taxpayer contributes a remainder interest in a painting which he owns to a charity, reserving to himself the right to possession of the painting during his lifetime, the retention of the right to possession is treated as a postponement in the payment of such contribution until his right to possession terminates. Thus, if the taxpayer subsequently transfers his intervening right to possession to the charity, or to an unrelated person (a person who does not stand in a relationship to the donor which is set forth in sec. 267(b)), payment of the remainder interest is thereupon deemed to have been completed and the value of such interest (computed as of the date the contribution is deemed to have been completed) is allowed as a deduction, subject to the limitations imposed by subsection (b) of section 170, in the year the donor's intervening right to possession is transferred. On the other hand, if the taxpayer retains any right to possession of the painting until his death, he is not entitled to an income tax deduction with respect to the remainder interest transferred on any return during his lifetime or on his final return. However, the retention of the right to possession until death would result in the inclusion of the painting in the taxpayer's gross estate and a deduction for the included value would be allowed to his estate, as a charitable transfer, for estate tax purposes.

Effective date

The amendments made by subsection (e) of the bill shall apply to transfers of future interests made after December 31, 1963, in taxable years ending after such date.

SECTION 210. LOSSES ARISING FROM EXPROPRIATION OF PROPERTY BY GOVERNMENTS OF FOREIGN COUNTRIES

Section 210 of the bill, which is a new section added to the bill as passed by the House, amends section 172 of the code to provide a 10-year carryover of certain expropriation losses.

(*a*) *Net operating loss carryover.*—Under the existing section 172(b)(1) of the code, relating to years to which a net operating loss may be carried, generally a net operating loss for any taxable year is a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss and is a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

Paragraph (1) of section 210(a) of the bill, as added by your committee, amends subparagraph (A)(i) of section 172(b)(1) of the code, relating to years to which a net operating loss may be carried, to provide that the 3-year carryback rule does not apply to the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss.

Paragraph (2) of section 210(a) of the bill, as added by your committee, amends subparagraph (B) of section 172(b)(1) of the code

to provide that the 5-year carryover rule does not apply to the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss.

Paragraph (3) of section 210(a) of the bill, as added by your committee, amends section 172(b)(1), relating to years to which a net operating loss may be carried, by adding to such section a new subparagraph (D). The new subparagraph (D) of section 172(b)(1) of the code provides that in the case of a taxpayer which has a foreign expropriation loss for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss. The term "foreign expropriation loss" is defined in a new subsection (k) added to section 172 of the code by paragraph (5) of section 210(a) of the bill, as added by your committee.

Paragraph (4) of section 210(a) of the bill, as added by your committee, amends section 172(b)(3), relating to special rules for net operating loss carrybacks and carryovers, by adding to such section new subparagraphs (C) and (D). Clause (i) of the new subparagraph (C) provides that the new subparagraph (D) of section 172(b)(1) of the code which allows the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss to be carried forward for 10 years shall apply only if the foreign expropriation loss for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year.

Clause (ii) of the new subparagraph (C) provides that, in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the new 10-year carryover provision shall apply only if the taxpayer elects (at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes) to have such new subparagraph (D) of section 172(b)(1) of the code apply.

Clause (iii) of the new subparagraph (C) provides that, in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the new 10-year carryover provision shall apply only if the taxpayer elects (in such manner as may be prescribed by the Secretary of the Treasury or his delegate) on or before December 31, 1965, to have such new subparagraph (D) of section 172(b)(1) of the code apply.

The new subparagraph (D) of section 172(b)(3) of the code provides that if a taxpayer makes an election under such subparagraph (C)(iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by such election (1) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966, (2) any deficiency attributable to the election under subparagraph (C)(iii) of section 172(b)(3) of the code or the application of clause (i) of section 172(b)(3)(D) of the code may be assessed at any time before January 1, 1969, and (3) refund or credit of any overpayment attributable to the election under subparagraph (C)(iii) of section 172(b)(3) of the code or the

application of clause (i) of section 172(b)(3)(D) of the code may be made or allowed if claim therefor is filed before January 1, 1969. In the event that the period within which a deficiency may be assessed or a claim for refund filed would expire at a date subsequent to January 1, 1969, under section 6501 or 6511 of the code, then such later date shall apply.

Paragraph (5) of section 210(a) of the bill, as added by your committee, amends section 172, relating to net operating loss deduction, by redesignating the existing subsection (k) as subsection (l) and by adding to such section a new subsection (k). The new subsection (k) provides that (1) the term "foreign expropriation loss" means, for any taxable year, the sum of the losses sustained with respect to property by reason of the expropriation, intervention, seizure, or similar taking of such property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, and (2) the portion of the net operating loss for such year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such year (but not in excess of the net operating loss for such year). The amount of any loss sustained is determined under section 165 of the code.

(*b*) *Technical amendments.*—Paragraph (1) of section 210(b) of the bill, as added by your committee, amends subparagraph (B) of section 172(b)(2) of the code, relating to amount of carrybacks and carryovers, by placing the existing provisions of such subparagraph (B) in a new subparagraph (B)(i) and by adding to such section a new subparagraph (B)(ii). Under existing section 172(b)(2) of the code the portion of a net operating loss which shall be carried to each of the taxable years other than the earliest taxable year to which such loss may be carried shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. The new subparagraph (B)(ii) provides that, in computing taxable income for any such prior taxable year, the amount of the net operating loss deduction shall be determined without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D) of section 172(b) of the code, be carried back to such prior taxable year.

Paragraph (2) of section 210(b) of the bill, as added by your committee, amends section 172(b)(2), relating to amount of carrybacks and carryovers, by adding at the end of such section a new sentence. The new sentence provides, in effect, that the portion of a net operating loss for a loss year attributable to a foreign expropriation loss shall be considered to be a separate net operating loss for such loss year. Such portion attributable to a foreign expropriation loss is to be applied after the other portion of such net operating loss for such loss year, but prior to any net operating losses for subsequent taxable years.

(*c*) *Effective date.*—Subsection (c) of section 210 of the bill, as added by your committee, provides that the amendments made by such section 210 shall apply in respect of foreign expropriation losses sustained in taxable years ending after December 31, 1958.

SECTION 211. ONE-PERCENT LIMITATION ON MEDICINE AND DRUGS

Section 211 of the bill (sec. 210 of the bill as passed by the House) has been approved by your committee without change. For the technical explanation of this section of the bill, see page 299 of the report of the Committee on Ways and Means on the bill.

SECTION 212. CARE OF DEPENDENTS

Section 212 of the bill (sec. 211 of the bill as passed by the House) amends section 214 of the code (relating to expenses for care of certain dependents). Subsections (a), (c), and (d) of section 214 of the code as amended by the bill as passed by the House and the effective date provision for this section of the bill have been approved by your committee without change. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page 300 of the report of the Committee on Ways and Means on the bill.

Subsection (b) of section 214, as amended by the bill as passed by the House, prescribed certain limitations on the allowability of the deduction otherwise authorized by subsection (a) of such section. The changes made by your committee in respect of these limitations are discussed below.

Dollar amount

Under the bill as passed by the House, subsection (b) of section 214 limited the deduction under section 214(a) to $600 for any taxable year except that such limit would be increased (to an amount not above $900) by the amount of expenses incurred by a taxpayer for any period during which the taxpayer had two or more dependents (within the meaning of amended sec. 214(d)(1) of the code). However, in the case of a woman who is married, the $600 limit would be increased only in respect of expenses incurred during a period while her husband was incapable of self-support because mentally or physically defective.

As amended by your committee, subsection (b) of section 214 limits the deduction under section 214(a) to $600 for any taxable year, except that such $600 limit—

(1) shall be increased (to an amount not above $900) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had two dependents (within the meaning of amended sec. 214(d)(1) of the code), and

(2) shall be increased (to an amount not above $1,000) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had three or more dependents (within the meaning of amended sec. 214(d)(1) of the code).

The provision of the bill as passed by the House dealing with the increase in the $600 limit in the case of a married woman (see the last sentence of the preceding paragraph) has been deleted.

Working wives and husbands with incapacitated wives

Under the bill as passed by the House, subsection (b) of section 214 further provided, in the case of a woman who is married and a husband whose wife is incapacitated, that the deduction otherwise allowable under section 214(a)—

(1) would not be allowed unless the couple files a joint return; and

(2) would be reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $4,500.

These conditions, however, were made inapplicable in certain specified situations.

The foregoing provisions of the bill as passed by the House have been approved by your committee and have been combined into one paragraph with an amendment providing that the deduction otherwise allowable under section 214(a) is to be reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $7,000 (rather than $4,500 as provided in the bill as passed by the House).

SECTION 213. MOVING EXPENSES

Section 213 of the bill (sec. 212 of the bill as passed by the House) has been approved by your committee except for a change in the effective date provision in subsection (d). The amendment made by subsection (c) of section 213 (relating to the definition of "wages" for withholding purposes) applied, under the bill as passed by the House, with respect to remuneration paid after December 31, 1963. As amended by your committee, such provision applies with respect to remuneration paid after the seventh day following the date of enactment of the bill.

For the technical explanation of this section of the bill, see page 305 of the report of the Committee on Ways and Means on the bill.

SECTION 214. DEDUCTION FOR POLITICAL CONTRIBUTIONS

Section 214 of the bill, which is a new section added to the bill as passed by the House, relates to a deduction for certain political contributions in computing taxable income.

(*a*) *Allowance of deduction.*—Subsection (a) of section 214 of the bill amends part VII of subchapter B of chapter 1 (relating to additional itemized deductions for individuals) of the Internal Revenue Code of 1954 by inserting after section 217 (as added by sec. 213(a)(1) of the bill) a new section 218.

SECTION 218. CONTRIBUTIONS TO POLITICAL CANDIDATES AND POLITICAL COMMITTEES

Subsection (a) of section 218 allows an individual a deduction for any political contribution (as defined in subsec. (c)), payment of which is made during the taxable year. The deduction will be allowable only for the taxable year in which the contribution is paid. The method of accounting employed by the taxpayer and the time when the contribution is pledged are immaterial.

Subsection (b)(1) of section 218 limits the deduction under subsection (a) to an aggregate of $50 for any taxable year except that in the case of husband and wife filing a joint return, the deduction for any year is limited to $100. The amount of the deduction in the case of a joint return will not be affected even though the contributions are made by only one spouse.

Subsection (b)(2) of section 218 provides that the deduction under subsection (a) shall be allowed only if the political contribution is verified in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

The term "political contribution" is defined in subsection (c) of section 218 as a contribution or gift to a political candidate or a political committee for the purpose of furthering the candidacy of one or more individuals in a general, special, or primary election or in a convention of a political party. A contribution to an organization which engages in activities in addition to influencing the election of political candidates, such as general political education, could qualify if such contribution is made to further the candidacy of one or more individuals in a general, special, or primary election or in a convention of a political party and if the funds received from such contributions are segregated from funds for such other activities. The principles applicable under section 170 of the code (relating to charitable contributions) will be followed in determining what constitutes a contribution or gift and the amount thereof. Thus, only that portion of the cost of tickets to fund-raising dinners which represents the excess of the price of the ticket over the amount which would ordinarily be paid for the dinner will qualify as a contribution. In addition, the value of services rendered to a candidate or committee will not qualify as a contribution.

(*b*) *Technical amendment.*—Subsection (b) of section 214 of the bill amends section 642 of the code (relating to special rules for credits and deductions of estates and trusts) by redesignating subsection (i) as subsection (j) and inserting a new subsection (i) which provides that an estate or trust is not allowed the deduction for political contributions provided under section 218.

(*c*) *Effective date.*—Under subsection (c) of section 214 of the bill, only contributions or gifts payment of which is made on or after the date of the enactment of the bill in taxable years ending after such date will be allowable as a deduction under new section 218 of the code.

SECTION 215. 100 PERCENT DIVIDENDS RECEIVED DEDUCTION FOR MEMBERS OF ELECTING AFFILIATED GROUPS

Section 215 of the bill, which is a new section added to the bill as passed by the House, amends section 243 of the code (relating to the deduction for certain dividends received by corporations), and makes conforming technical amendments.

(*a*) *100 percent dividends received deduction.*—Subsection (a) of section 243, as amended, in substance incorporates the provisions of subsections (a) and (b) of existing section 243. Paragraph (1) of subsection (a) corresponds to subsection (a) of existing section 243 and paragraph (2) of subsection (a) corresponds to subsection (b) of existing section 243. Paragraph (3) of subsection (a), which has no counterpart in existing law, provides for a 100 percent deduction in the case of "qualifying dividends."

Qualifying dividends

Subsection (b)(1) of section 243, as amended, defines the term "qualifying dividends" to mean dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in par (5)

of sec. 243(b)) as the corporation distributing the dividends, provided that the conditions prescribed in subparagraphs (A) and (B) of section 243(b)(1) are met.

Subparagraph (A) of section 243(b)(1) provides that such affiliated group which includes the distributing and recipient corporations must have made an election (under par. (2) of sec. 243(b)) which is effective for the taxable years of its member corporations which include the day of receipt.

Subparagraph (B) of section 243(b)(1) provides that such dividends must have been distributed out of earnings and profits of a taxable year which ends after December 31, 1963, and with respect to which two requirements are satisfied. First, under clause (i) of subparagraph (B), on each day of such taxable year the distributing corporation and the recipient corporation must have been members of such affiliated group. Second, under clause (ii) of subparagraph (B), an election under section 1562 (relating to election of multiple surtax exemptions) must not be effective for such taxable year.

The application of the provisions of section 243(b)(1) may be illustrated by the following examples:

Example (1).—On March 1, 1964, corporation P, a publicly owned corporation, acquires all the stock of corporations S and S–1 and continues to hold such stock throughout the remainder of 1964 and all of 1965. Corporations P, S, and S–1 are domestic corporations which file separate returns on the basis of a calendar year. An election under section 1562 was not effective for their taxable years ending December 31, 1964, and December 31, 1965. Corporation S makes a $5,000 distribution with respect to its stock on February 1, 1965, which is received by corporation P on the same date. Before taking into account this distribution, corporation S had earnings and profits for its taxable years ending December 31, 1964, and December 31, 1965, of $7,000 and $4,000, respectively. An election under section 243(b)(2) is effective for the taxable years of corporations P, S, and S–1 which include February 1, 1965. Accordingly, corporation P will be entitled to a 100 percent dividends received deduction under section 243(a)(3) with respect to $4,000 of the $5,000 distribution received from corporation S on February 1, 1965. Since $1,000 of the $5,000 distribution was made out of earnings and profits of corporation S for its taxable year ending December 31, 1964, and since corporations P and S were not members of the same affiliated group of corporations on each day of such year, $1,000 of the February 1, 1965, distribution would not constitute a qualifying dividend as defined in section 243(b)(1) (but would constitute a dividend entitled to an 85 percent dividends received deduction under sec. 243(a)(1)).

Example (2).—Assume the same facts as in example (1), except that corporation P held all the stock of corporations S and S–1 on each day of 1964 and sold the stock of S on November 1, 1965. Since an election under section 243(b)(2) is effective for the taxable years of corporations P, S, and S–1 which include February 1, 1965, corporation P will be entitled to a 100 percent dividend received deduction under section 243(a)(3) with respect to $1,000 of the $5,000 distribution received from corporation S on February 1, 1965. The $1,000 amount represents the portion of the February 1, 1965, distribution which was made out of the earnings and profits of corporation S for its taxable year ending December 31, 1964, a year for which the

requirements of section 243(b)(1) are met. Since $4,000 of the $5,000 distribution was made out of the earnings and profits of corporation S for its taxable year ending December 31, 1965, and since corporations P and S were not members of the same affiliated group of corporations on each day of such year, $4,000 of the February 1, 1965, distribution would not constitute a qualifying dividend as defined in section 243(b)(1) (but would constitute a dividend entitled to an 85 percent dividends received deduction under sec. 243(a)(1)).

Election

Paragraph (2) of section 243(b), as amended, provides that an election (referred to in subpar. (A) of sec. 243(b)(1)) is to be made by the common parent corporation for the affiliated group of corporations. The election is to be made with respect to a particular taxable year of the common parent corporation and is to be made at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes. An election may not be made for an affiliated group for any taxable year of the common parent corporation for which an election under section 1562 (relating to election of multiple surtax exemptions) is effective. A consent is required from each corporation which is a member of the affiliated group at any time during its taxable year which includes the last day of the particular taxable year of the common parent corporation with respect to which the election is made. The consent is to be made at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes.

Under subparagraph (A) of paragraph (2), an election will be effective for the taxable year of each member of the affiliated group which includes the last day of the taxable year of the common parent corporation with respect to which the election is made. However, in the case of a taxable year of a member beginning in 1963 and ending in 1964, if an election is made with respect to a taxable year of the common parent corporation which includes the last day of such taxable year of such member, then the election will be effective with respect to such taxable year of such member if it consents to such election with respect to such taxable year. Under subparagraph (B) of paragraph (2), an election will also be effective (unless terminated under par. (4) of subsec. (b)) for the taxable year of each member which ends after the last day of the taxable year of the common parent corporation with respect to which the election is made but which does not include such last day.

The application of the provisions of section 243(b)(2) may be illustrated by the following example:

Example.—Corporation P is a common parent corporation of an affiliated group of corporations consisting of corporations P and S. Corporation P files its income tax return on the basis of a fiscal year ending June 30 and corporation S uses a calendar year as the basis for its tax return. Corporation P makes an election under section 243(b)(2) with respect to its taxable year ending June 30, 1965. If the election is properly consented to by P and S, the election will be effective with respect to the fiscal year of corporation P ending June 30, 1965, and with respect to the calendar year of corporation S ending December 31, 1965 (the year including June 30, 1965, the last day of the common parent corporation's taxable year with respect to

which the election was made). Further, if corporation Y, which has a fiscal year ending September 30, becomes a member of such affiliated group on June 15, 1966, the election will be effective with respect to corporation Y's taxable year ending September 30, 1966, as well as P's taxable year ending June 30, 1966, and S's calendar year ending December 31, 1966, unless the election is terminated under paragraph (4) of section 243(b).

Effect of election

Paragraph (3) of section 243(b), as amended, provides that if an election, made for an affiliated group of corporations under paragraph (2) of section 243(b), is effective with respect to any taxable year of the common parent corporation, then under regulations prescribed by the Secretary of the Treasury or his delegate—

(1) no member of such affiliated group may consent to an election under section 1562 for such taxable year;

(2) the members of such group will be treated as one taxpayer for purposes of making the elections under section 901(a) (relating to allowance of foreign tax credit) and section 904(b)(1) (relating to election of overall limitation); and

(3) the members of such affiliated group will be limited to (i) one $100,000 mimimum accumulated earnings credit under section 535(c) (2) or (3); (ii) one $100,000 limitation for exploration expenditures under section 615 (a) and (b); (iii) one $400,000 limitation for exploration expenditures under section 615(c)(1); (iv) one $25,000 limitation on small business deductions of life insurance companies under sections 804(a)(4) and 809(d)(10); and (v) one $100,000 exemption for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax.

Termination

Paragraph (4) of section 243(b), as amended, provides for the termination of an election under paragraph (2). Such termination, if made, is effective with respect to a taxable year of the common parent corporation and with respect to the taxable years of the members of the affiliated group which includes the last day of such taxable year of the common parent corporation. Under subparagraph (A) of paragraph (4), an election will be terminated if the affiliated group files, with respect to a particular taxable year of the common parent corporation, a termination of such election (at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes). Each corporation which is a member of the affiliated group at any time during its taxable year which includes the last day of such taxable year of the common parent corporation must consent to the termination of the election.

Under subparagraph (B) of paragraph (4), an election will be terminated with respect to a taxable year of the common parent corporation if with respect to such year the affiliated group includes a member which was not a member of such group during such common parent corporation's immediately preceding taxable year, and if such member files a statement that it does not consent to the election at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes.

Definition of affiliated group

Paragraph (5) of section 243(b), as amended, defines the term "affiliated group" for purposes of subsection (b) of section 243. The term is to have the same meaning assigned to it by section 1504(a) except that section 1504(b)(2) and section 1504(c) will not apply. Thus, for purposes of section 243(b), an affiliated group includes those domestic corporations (including a corporation which is treated as a domestic corporation under sec. 1504(d)) which meet the stock-ownership test contained in section 1504(a), and which are "includible corporations" within the meaning of section 1504(b); however, any domestic insurance company subject to taxation under section 802 or 821 will be treated for this purpose as an includible corporation.

Special rules for insurance companies

Paragraph (6) of section 243(b), as amended, provides special rules for certain insurance companies. Subparagraph (A) of paragraph (6) provides that if an election under subsection (b) of section 243 is effective for the taxable year of an insurance company subject to taxation under section 802 or 821 of the code, then part II of subchapter B of chapter 6 of the code (relating to certain controlled corporations) will be applied without regard to section 1563(a)(4) (relating to certain insurance companies) and section 1563(b)(2)(D) (relating to certain excluded members) with respect to such company and the other corporations which are members of the controlled group of corporations (as determined under sec. 1563 without regard to subsecs. (a)(4) and (b)(2)(D)) of which such company is a member. Subparagraph (B) of paragraph (6) provides that if an insurance company subject to taxation under section 802 or 821 distributes a dividend out of earnings and profits of a taxable year with respect to which the company would have been a component member of a controlled group of corporations within the meaning of section 1563 except for subsection (b)(2)(D) thereof, such dividend will not be treated as a qualifying dividend unless an election under subsection (b) of section 243 is effective for such taxable year.

The application of the provisions of paragraph (6) of section 243(b) may be illustrated by the following example:

Example.—Throughout 1965 corporation M owns all the stock of corporations L, X, and Y. Corporation M is a domestic mutual insurance company subject to tax under section 821 of the code, corporation L is a domestic life insurance company subject to tax under section 802 of the code, and corporations X and Y are subject to tax under section 11 of the code. Each corporation uses the calendar year for its taxable year. Corporation L pays a dividend to corporation M in 1965 which is out of the earnings and profits of L's taxable year ending on December 31, 1965. Corporation M makes an election under section 243(b)(2) for 1965 for the affiliated group consisting of corporations M, L, X, and Y which is properly consented to by such corporations. The application of paragraph (6) of section 243(b) results in the following tax consequences:

(1) As a result of applying part II of subchapter B of chapter 6 in the manner described in subparagraph (A) of section 243(b)(6), corporations M, L, X, and Y will be limited to a single $25,000 surtax exemption for their taxable years ending December 31, 1965 (to be apportioned among such corporations in accordance with sec. 1561).

Although M and L are excluded members of the controlled group of corporations consisting of corporations M, L, X, and Y, by reason of the application of the excluded member rule contained in subparagraph (D) of section 1563(b)(2), subparagraph (A) of section 243(b)(6) requires that part II of subchapter B of chapter 6 of the code be applied with respect to M and L and the other members of the controlled group without regard to such rule.

(2) The distribution by corporation L to corporation M is a qualifying dividend within the meaning of paragraph (1) of section 243(b). Since the distribution is out of the earnings and profits of L for its taxable year ending December 31, 1965 (a year in which L would have been a component member of a controlled group of corporations within the meaning of sec. 1563 except for the excluded member rule contained in subsec. (b)(2)(D)), and an election under paragraph (2) of section 243(b) is in effect for such taxable year, the dividend is not disqualified by operation of subparagraph (B) of section 243(b)(6).

Subsection (c) of section 243, as amended, includes a new paragraph (4). New paragraph (4) provides that any dividend received which is described in section 244 (relating to dividends received on preferred stock of a public utility), as amended by subsection (b)(1) of this section of the bill, shall not be treated as a dividend for purposes of section 243, as amended. The corresponding provisions of existing law appear as parenthetical phrases in existing subsections (a) and (b) of section 243.

Subsection (d) of section 243, as amended, is the same as existing section 243(d) except for a conforming change.

(*b*) *Technical amendments.*—Subsection (b) of section 215 of the bill makes technical amendments to several sections of the code to conform them to the amendments made by subsection (a) of this section of the bill.

(*c*) *Effective date.*—Subsection (c) of section 215 of the bill provides that the amendments made by subsections (a) and (b) of such section shall apply with respect to dividends received in taxable years ending after December 31, 1963.

SECTION 216. INTEREST ON LOANS INCURRED TO PURCHASE CERTAIN INSURANCE AND ANNUITY CONTRACTS

Section 216 of the bill (section 213 of the bill as passed by the House) amends section 264 of the code to provide that, under certain circumstances, no deduction is allowed for interest on loans incurred or continued to purchase or carry certain life insurance, endowment, or annuity contracts. For a technical explanation of this section of the bill (other than the amendment made by your committee), see page 308 of the report of the Committee on Ways and Means on the bill.

Subsection (a)(2) of this section of the bill as passed by the House provided that new paragraph (3) of section 264(a) of the code (added by subsec. (a)(1) of sec. 216 of the bill) would apply only in respect of contracts purchased after August 6, 1963. Under your committee's amendment, new paragraph (3) of section 264(a) of the code applies only in respect of contracts purchased after December 31, 1963.

SECTION 217. INTEREST ON INDEBTEDNESS INCURRED OR CONTINUED TO PURCHASE OR CARRY TAX-EXEMPT BONDS

Section 217 of the bill, which is a new section added to the bill as passed by the House, amends section 265(2) of the code by adding a new sentence at the end thereof.

Section 265(2) presently provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations (other than certain obligations of the United States) the interest from which is wholly exempt from the taxes imposed by subtitle A of the code (relating to income taxes).

(*a*) *Application with respect to certain financial institutions.*—Section 217(a) limits the application of section 265(2) in the case of interest expense in respect of face-amount certificates issued by a financial institution (other than a bank) which is subject to the banking laws of the State in which such institution is incorporated. The amendment does not affect the application of section 265(2) in the case of banks.

Under section 265(2), as amended, interest expense incurred by such an institution—

(1) on face-amount certificates (as defined in sec. 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. 80a–2)) issued by the institution, and

(2) on amounts received by such institution to be applied toward the purchase of such face-amount certificates to be issued by the institution

is not to be considered as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by subtitle A of the code to the extent that the average amount of such obligations held by such institution during the taxable year does not exceed 25 percent of the average of the total assets of the institution during the taxable year.

The Secretary of the Treasury or his delegate is required to prescribe by regulations the manner of computing the average amount of tax-exempt obligations held by such institution during the taxable year, and the manner of determining the average amount of the total assets held by such institution during the taxable year.

The computation of the average amount of tax-exempt obligations and the average amount of total assets is to be made not more frequently than weekly. Thus, if the Secretary or his delegate prescribes that such averages are to be computed as of the end of each week of the institution's taxable year, the percentage which the average amount of tax-exempt obligations is of the average amount of total assets of the institution for any taxable year shall be computed by dividing—

(1) the sum of the investments of the institution, as of the end of each week of its taxable year, in obligations the interest on which is wholly tax-exempt, by

(2) the sum of the total assets of the institution as of the end of each week of its taxable year.

If this computation results in a percentage figure in excess of 25 percent, there is interest on indebtedness which is subject to the first sentence of section 265(2). The amount thereof is obtained by multi-

plying the total interest expense for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage equal to the excess of such percentage figure over 25 percent.

In addition, any other interest expense of such institution is subject to the first sentence of section 265(2).

(*b*) *Effective date.*—Section 217(b) provides that the amendment made by section 217(a) shall apply with respect to taxable years ending after the date of enactment of the bill.

SECTION 218. REPEAL OF REQUIREMENT OF ALLOCATION OF CERTAIN TRAVELING EXPENSES

(*a*) *Repeal of section 274(c).*—Subsection (a) of section 218 of the bill, which is a new section added to the bill as passed by the House, amends section 274 of the code by repealing subsection (c) thereof. Section 274(c) provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. Such provision, however, does not apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or to an activity specified in section 212 is less than 25 percent of the total time away from home on such travel.

(*b*) *Effective date.*—Subsection (b) of section 218 of the bill provides that the repeal made by this section shall apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

SECTION 219. ACQUISITION OF STOCK IN EXCHANGE FOR STOCK OF CORPORATION WHICH IS IN CONTROL OF ACQUIRING CORPORATION

(*a*) *Definition of reorganization.*—Subsection (a) of section 219 of the bill, which is a new section added by your committee to the bill as passed by the House, amends subparagraph (B) of section 368(a)(1) of the code, relating to definition of a stock-for-stock reorganization. Under the existing section 368(a)(1)(B), the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation qualifies as a "reorganization" if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

Subparagraph (B) of section 368(a)(1) of the code, as amended by this section of the bill, allows an acquiring corporation to exchange either its voting stock or the voting stock of a corporation which is in control of the acquiring corporation for the stock of another corporation.

(*b*) *Technical amendments.*—Paragraph (1) of section 219(b) of the bill, as added by your committee, amends subparagraph (C) of section 368(a)(2) of the code, relating to special rules. Under the existing section 368(a)(2)(C), a transaction otherwise qualifying as a "reorganization" under subparagraph (A) or (C) of section 368(a)(1), which relate respectively to statutory mergers or consolidations and stock-for-property reorganizations, is not disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

Subparagraph (C) of section 368(a)(2) of the code, as amended by this section of the bill, allows a corporation acquiring stock in a transaction otherwise qualifying as a "reorganization" under section 368(a)(1)(B), as amended by this section of the bill, to transfer part or all of such stock to a corporation controlled by the corporation acquiring such stock.

Paragraph (2) of section 219(b) of the bill, as added by your committee, amends the last two sentences of subsection (b) of section 368, relating to definition of a party to a reorganization.

The next to last sentence of section 368(b) of the code, as amended by this section of the bill, provides that in the case of a reorganization qualifying under subparagraph (B) or (C) of section 368(a)(1), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. The last sentence of the amended section 368(b) of the code provides that in the case of a reorganization qualifying under subparagraph (A), (B), or (C) of section 368(a)(1) by reason of subparagraph (C) of section 368(a)(2), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred.

(*c*) *Effective date.*—Subsection (c) of section 219 of the bill, as added by your committee, provides that the amendments made by such section shall apply with respect to transactions after December 31, 1963, in taxable years ending after such date.

SECTION 220. RETROACTIVE QUALIFICATION OF CERTAIN UNION-NEGOTIATED MULTIEMPLOYER PENSION PLANS

(*a*) *Beginning of period as qualified trust.*—Subsection (a) of section 220 of the bill, which is a new section added by your committee to the bill as passed by the House, amends section 401 of the code by redesignating subsection (i) as (j), and by inserting a new subsection (i). Section 401 relates to qualified pension, profit-sharing, and stock bonus plans.

In general, under existing law, employer contributions to a pension trust are deductible only under the provisions of section 404 of the code. Deductibility under that section in effect requires, if the employees do not have a nonforfeitable right to the contributions at the time they are made, that the trust be part of a pension plan of an employer which qualifies under section 401(a) of the code. One of the requirements for qualification included in the Treasury Department's regulations under that section is that the plan be in

the form of "a definite written program and arrangement which is communicated to the employees." However, under a multiemployer collective bargaining agreement, employer contributions are often made to or for a pension trust before a complete schedule of benefits has been adopted, so that such contributions are not made to a qualified trust and, if not vested, are not deductible.

The new subsection (i) applies to a trust forming part of a pension plan which has been determined by the Secretary of the Treasury or his delegate to constitute a qualified trust under section 401(a), and to be exempt from taxation under section 501(a), for a period beginning after contributions were first made to or for such trust. The new subsection (i) provides that where such a trust meets certain conditions, then it shall be considered as having constituted a qualified trust under section 401(a), and as having been exempt from taxation under section 501(a), for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to the new subsection) a qualified trust.

The conditions referred to in the preceding paragraph require that it be shown to the satisfaction of the Secretary of the Treasury or his delegate that: (1) such trust was created pursuant to a collective bargaining agreement between employee representatives and two or more employers who are not related (determined under regulations prescribed by the Secretary of the Treasury or his delegate); (2) any disbursements made prior to the period for which the trust was determined to be qualified (without regard to the new subsection) substantially comply with the terms of the trust (and plan) as so qualified; and (3) prior to the period for which the trust was determined to be qualified (without regard to the new subsection) contributions were not used in a manner which jeopardized the interests of the beneficiaries.

In some cases, employer contributions are held in escrow until such time as a trust is created. For purposes of applying the new subsection (i), such employer contributions which are held in escrow and later transferred to a qualified trust are "contributions made to or for such trust."

(*b*) *Effective date.*—Subsection (b) of section 220 of the bill provides that the amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954. However, no provision of this section extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS

Section 221 of the bill, which is a new section added to the bill as passed by the House, relates to the provision of qualified pension, profit-sharing, etc., plan coverage for certain employees of subsidairy corporations.

(*a*) *Employees of foreign subsidiaries covered by social security agreements.*—Subsection (a) of section 221 of the bill adds a new section 406 to part I of subchapter D of chapter 1 of the Internal Revenue

Code of 1954 (relating to pension, profit-sharing, stock bonus plans, etc.). The new section 406 relates to qualified pension, profit-sharing, etc., plan coverage for certain employees of foreign subsidiaries.

SECTION 406. QUALIFIED PENSION, PROFIT SHARING, ETC., PLAN COVERAGE FOR CERTAIN EMPLOYEES OF FOREIGN SUBSIDIARIES

(*a*) *Treatment as employees of domestic corporation.*—The new section 406(a) sets forth the rules relating to the treatment of certain employees of foreign subsidiaries who are covered under a social security agreement described in section 3121(l) of the code, entered into at the request of the domestic corporation, as employees of such domestic corporation. The new section 406(a) only applies in the case of a plan established and maintained by a domestic corporation which is a pension, profit-sharing, or stock bonus plan described in section 401(a) of the code, an annuity plan described in section 403(a) of the code, or a bond purchase plan described in section 405(a) of the code. The new section 406(a) provides that in the case of such a plan an individual who is a citizen of the United States and who is also an employee of a foreign subsidiary (as defined in section 3121(l)(8) of the code) of the domestic corporation shall be treated as an employee of such domestic corporation if certain requirements are satisfied. Under the new section 406(a), the deemed employer-employee relationship can only exist if the plan of the domestic employer is qualified. However, if the plan of the domestic employer is qualified, then the fact that the trust which forms a part of such plan is not exempt from tax under section 501(a) of the code does not affect such employer-employee relationship.

The first of the requirements of the new section 406(a) is that the domestic corporation has entered into an agreement described in section 3121(l) of the code, relating to agreements entered into by domestic corporations with respect to foreign subsidiaries, and such agreement covers the foreign subsidiary of the domestic corporation in which the individual is employed. Therefore, there is brought into play, as a condition precedent to obtaining the benefits of section 406, the rules set forth in section 3121(l) which relate to the circumstances under which a domestic corporation may enter into an agreement for the purpose of extending the benefits provided by title II of the Social Security Act to certain services performed outside the United States, and to the obligations of the domestic corporation which enters into such an agreement.

The second requirement is that the qualified plan of the domestic employer must expressly provide coverage for the U.S. citizen employees of all foreign subsidiaries which are covered under the agreement described in section 3121(l) of the code which has been entered into by the domestic corporation. However, such requirement does not modify the requirements for qualification set forth in section 401(a) of the code which are applicable to such plan. Thus, such plan must satisfy the requirements of section 401(a) after such plan is amended to cover individuals who are employees within the meaning of section 406(a). The plan need not provide actual benefits for all citizen employees of all such foreign subsidiaries; for example, some such employees may not receive benefits if they are excluded by reason of a nondiscriminatory classification or other provision of the plan.

The third requirement for qualification of an individual as an employee is that contributions under a funded plan of deferred compensation are not provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary. Contributions are provided under a funded plan of deferred compensation; for example, if contributions are provided for such individual under a plan described in section 401(a) of the code, section 403(a) of the code, or section 405(a) of the code. If any portion of such remuneration is covered under another plan by a person other than the domestic parent, such employee cannot be treated as the employee of the domestic corporation.

(*b*) *Special rules for application of section 401*(*a*).—The new section 406(b) provides certain special rules for the application of section 401(a) of the code in the case of a plan which covers an individual who is treated as an employee of a domestic corporation under the new section 406(a).

Paragraph (1) of such section 406(b) provides certain rules regarding the application of section 401(a) (3)(B) and (4) of the code in the case of a plan which covers such an individual. Paragraph (1)(A) of section 406(b) provides that if such an individual is an officer, shareholder, or person whose principal duties consist in supervising the work of other employees of a foreign subsidiary of such domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation. Thus, for example, if an individual who is an employee within the meaning of section 406(a) is an officer of a foreign subsidiary, he is considered to be an officer of the domestic corporation treated as his employer for the purpose of determining whether the plan of such domestic employer satisfies the nondiscrimination requirements of section 401(a) (3)(B) and (4).

Paragraph (1)(B) of section 406(b) provides that the determination of whether an individual who is treated as an employee under the new section 406(a) is a highly compensated employee for purposes of section 401(a) (3)(B) and (4) of the code is made by treating such individual's total compensation (as computed in accordance with the provisions of par. (2) of sec. 406(b)) as compensation paid by the domestic corporation and by determining such individual's status as a highly compensated employee with regard to such domestic corporation.

Paragraph (2) of the new section 406(b) sets forth the rules regarding determination of the compensation of an individual who is treated as an employee of a domestic corporation under section 406(a) of the code. Such rules are applicable whenever the compensation of such an individual is to be determined for the purpose of determining whether the plan satisfies the requirements for qualification set forth in section 401(a). Paragraph (2)(A) of section 406(b) provides that, for the purpose of applying section 401(a)(5) with respect to such an individual, his total compensation is the remuneration paid to him by the foreign subsidiary which would constitute his total compensation if his services had been performed for the domestic corporation treated as his employer. In addition, such paragraph (2)(A) provides that the portion of the individual's total compensation which constitutes his basic or regular rate of compensation shall be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Paragraph (2)(B) of section 406(b) provides that an individual who is treated as an employee under section 406(a) shall be treated as having paid the amount paid by such domestic corporation which is equivalent to the tax imposed by section 3101 of the code (relating to the tax imposed on employees) with respect to such individual. Thus, the administrative rules relating to the determination of the contributions or benefits provided by the employer under the Social Security Act apply for purposes of determining whether the plan meets the requirements of section 401.

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—The new section 406(c) provides that the termination of status as an employee within the meaning of section 406(a) shall not be treated as separation from service for purposes of sections 402(a)(2) and 403(a)(2) of the code which provide capital gains treatment for certain distributions which take place after an employee's separation from the service. Section 406(c) provides that for purposes of applying section 402(a)(2) and section 403(a)(2) with respect to the distribution of the total amounts payable to an individual who is treated as an employee of a domestic corporation under section 406(a), such individual is not treated as separated from the service of the domestic corporation solely by reason of the occurrence of certain events.

The provisions of section 406(c) are in addition to the rules of existing law regarding the determination as to whether an employee is separated from service. In general, these provisions take into account the deemed employer-employee relationship which is established under the new section 406 of the code and provide that the termination of such deemed relationship does not result in a separation from service.

Section 406(c) provides that for purposes of applying section 402(a)(2) and section 403(a)(2) of the code with respect to an individual who is treated as an employee of a domestic corporation under section 406(a), such individual shall not be treated as separated from the service solely by reason of the fact that—

(1) The agreement entered into by such domestic corporation under section 3121(l) which covers the employment of such individual is terminated under the provisions of such section;

(2) Such individual becomes an employee of a foreign subsidiary (as defined in sec. 3121(l)(8)) with respect to which an agreement described in section 3121(l) does not apply;

(3) Such individual ceases to be an employee within the meaning of section 406(a) and becomes an employee of another corporation controlled by the domestic corporation; or

(4) The provision of the plan described in section 406(a)(2) is terminated.

For purposes of paragraph (3), above, a corporation is considered to be controlled by a domestic corporation if such domestic corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(*d*) *Deductibility of contributions.*—The new section 406(d) relates to the deductibility of contributions made on behalf of an individual who

is treated as an employee of a domestic corporation by reason of the provisions of section 406(a). The new section 406(d) provides that for purposes of applying sections 404 and 405(c) with respect to contributions made to a qualified plan on behalf of an individual who is treated as an employee of a domestic corporation under section 406(a), no domestic corporation is allowed a deduction. The amount which would be deductible under section 404 or 405(c) by the domestic corporation if the individual who is an employee within the meaning of section 406(a) were its own employee is allowed as a deduction to the foreign subsidiary. Thus, the foreign subsidiary is allowed the deduction under section 404(a) or 405(c), but such deduction is available to the foreign corporation only to the extent otherwise allowed under chapter 1 (see, for example, sec. 863 of the code).

Whether contributions on behalf of an individual who is treated as an employee under section 406(a), or forfeitures with regard to such employee, will result in an inclusion in the income of the domestic corporation, or an adjustment in the basis of such corporation's stock in the foreign corporation, will depend upon the rules of existing law. For example, an unreimbursed contribution by the domestic parent corporation to a plan under which each employee's rights to the contributions are nonforfeitable, will be treated as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of such subsidiary's employees.

Paragraph (3) of the new section 406(d) provides that for the purpose of computing the amount deductible under section 404 or 405(c) any reference to compensation shall be considered to be a reference to the total compensation of such individual determined with the application of the rules set forth in the new section 406(b)(2).

The new section 406(d) also provides that any amount deductible by a foreign subsidiary under this section shall be deductible for its taxable year with or within which the taxable year of the domestic corporation ends.

(*e*) *Treatment as employee under related provisions.*—The new section 406(e) provides that, for purposes of applying certain related provisions of the code, an individual who is treated as an employee of a domestic corporation under the new section 406(a) is also to be treated as an employee of the domestic corporation with respect to certain related provisions dealing with the tax treatment of qualified plans. This section permits employees of subsidiaries covered under the qualified plan of the domestic corporation and their beneficiaries to receive the same tax treatment afforded other employees of such corporation and their beneficiaries with respect to the taxation of annuities, the death benefit exclusion, the exemption from gross estate of annuities under certain trusts and plans, and the exclusion from gift tax in the case of certain annuities under qualified plans. The provisions specifically designed under subsection (e) are: (1) Section 72(d), relating to employees' annuities; (2) section 72(f), relating to special rules for computing employees' contributions; (3) section 101(b), relating to employees' benefits; (4) section 2039, relating to annuities; and (5) section 2517, relating to certain annuities under qualified plans.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS—Continued

(*b*) *Employees of domestic subsidiaries engaged in business outside the United States.*—Subsection (b) of section 221 of the bill amends part I of subchapter D of chapter 1 of the code (relating to pension, profit-sharing, stock bonus plans, etc.) by adding after section 406 of the code a new section 407. The new section 407 relates to certain employees of domestic subsidaries engaged in business outside the United States.

SECTION 407. CERTAIN EMPLOYEES OF DOMESTIC SUBSIDIARIES ENGAGED IN BUSINESS OUTSIDE THE UNITED STATES

(*a*) *Treatment as employees of domestic parent corporation.*—The new section 407(a) sets forth the requirements which must be satisfied for a U.S. citizen who is employed by a domestic subsidiary engaged in business outside the United States to be treated as an employee of the domestic parent corporation. Paragraph (1) of section 407(a) provides that for purposes of applying this part, with respect to a qualified plan described in either section 401(a), 403(a), or 405(a), of a domestic parent corporation, an individual who is a citizen of the United States and an employee of a domestic subsidiary (as defined in paragraph (2) of section 407(a)) of a domestic parent corporation shall be treated as an employee of the domestic parent corporation if two requirements are satisfied.

The first of these requirements is that the plan of the domestic parent corporation must expressly provide coverage for U.S. citizen employees of every domestic subsidiary (as defined in paragraph (2) of section 407(a)). The second requirement is that contributions must not be provided for the employee by any other person under a funded plan of deferred compensation (whether or not such plan is a qualified plan). Contributions are not provided under a funded plan, for example, merely because the domestic subsidiary employer pays the tax imposed by section 3111 with respect to an employee.

Paragraph (2) of the new section 407(a) provides certain definitions for purposes of section 407. Paragraph (2)(A) of section 407(a) defines the term "domestic subsidiary" for purposes of section 407. Such paragraph (2)(A) sets forth three requirements which must be satisfied in order for a domestic corporation to be classified as a "domestic subsidiary." First, the domestic parent corporation must own 80 percent or more of the outstanding voting stock of the subsidiary corporation. Second, 95 percent or more of the subsidiary corporation's gross income for the 3 taxable years of such subsidiary immediately preceding the close of the taxable year of the domestic parent corporation (or for such part of such period during which the corporation was in existence) must be derived from sources without the United States. The third requirement is that 90 percent or more of the subsidiary corporation's gross income for such period (or such part) must be derived from the active conduct of a trade or business.

Paragraph (2)(B) of section 407(a) defines the term "domestic parent corporation" for purposes of section 407. A domestic parent

corporation for purposes of such section is the domestic corporation which owns 80 percent or more of the outstanding voting stock of a domestic subsidiary (as defined in paragraph (2)(A)).

(*b*) *Special rules for application of section 401(a).*—The new section 407(b) provides special rules for the application of section 401(a). The rules are substantially the same as those prescribed in the new section 406(b) (1) and (2)(A), except that the provisions of section 407(b) relate to individuals who are employees within the meaning of section 407(a), and the technical explanation of the provisions of section 406(b) (1) and (2)(A) is applicable to the provisions of section 407(b).

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—The new section 407(c) relates to certain occasions when the termination of the status as an employee within the meaning of section 407 shall not be treated as separation from service for purposes of sections 402(a)(2) and 403(a)(2) of the code. The new section 407(c) provides that an individual who is an employee of a domestic subsidiary but who is treated as an employee of a domestic parent corporation under the new section 407(a) shall not be considered as separated from the service of the domestic parent corporation solely by reason of the fact that the domestic subsidiary ceases, for any taxable year, to be a subsidiary within the meaning of section 407(a)(2)(A). Thus, for example, even though an individual who is an employee of a domestic subsidiary could not be covered under the plan of the domestic parent corporation for any taxable year in which the domestic parent corporation owned only 72 percent of the outstanding voting stock of such domestic subsidiary, such individual would not be treated as separated from service of the domestic corporation for purposes of sections 402(a)(2) and 403(a)(2) of the code.

Section 407(c) also provides that an individual shall not be treated as separated from the service by reason of the fact that—

(1) such individual ceases to be an employee of a domestic subsidiary corporation and becomes an employee of another corporation controlled by the domestic parent corporation; or

(2) the plan no longer contains the provision described in section 407(a)(1)(A).

For purposes of paragraph (1), above, a corporation is considered to be controlled by a domestic parent corporation if such domestic parent corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(*d*) *Deductibility of contributions.*—The new section 407(d) provides rules relating to the deductibility of contributions made on behalf of an individual who is an employee within the meaning of section 407(a). These rules are substantially the same as the rules in the new section 406(d), except that the provisions of section 407 relate to contributions on behalf of employees of domestic subsidiaries.

(*e*) *Treatment as employee under related provisions.*—The substantive provisions of the new section 407(e) are the same as the new section 406(e), except that the provisions of section 407 relate to the tax treatment of employees of domestic subsidiaries.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS—Continued

(*c*) *Technical amendments.*—Subsection (c) of section 221 of the bill sets forth certain technical amendments. Paragraph (1) of section 221(c) amends the table of sections for part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 to reflect the addition of new sections 406 and 407 of the code. Paragraph (2) of section 221(c) amends section 3121(a)(5) of the code, relating to definition of wages, to conform such definition to the provisions relating to the qualification of plans of deferred compensation which are contained in part I of subchapter D of chapter 1. Paragraph (3) of section 221(c) amends section 209(e) of the Social Security Act, relating to the definition of wages, in order to conform the provisions of this section to the provisions of section 3121(a)(5) of the code, as amended by paragraph (2) of section 221(c) of the bill.

(*d*) *Effective date.*—Subsection (d) of section 221 of the bill provides that the amendments made by subsections (a), (b), and (c)(1) of section 221 will be applicable to taxable years ending after December 31, 1963, and that the amendments made by subsections (c) (2) and (3) of section 221 shall apply to remuneration paid after December 31, 1962.

SECTION 222. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS

Section 222 of the bill (sec. 214 of the bill as passed by the House) has been approved by your committee with the amendments explained hereinafter. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page 311 of the report of the Committee on Ways and Means on the bill.

(*a*) *In general.*—Subsection (a) of this section of the bill as passed by the House has been amended by your committee as follows:

SECTION 422. QUALIFIED STOCK OPTIONS

(*a*) *Qualified stock option.*—Under the bill as passed by the House, section 422(b) of the code defined the term "qualified stock option" as an option granted to an individual after June 11, 1963 (other than a restricted stock option granted pursuant to a contract described in sec. 424(c)(4)(A) (sec. 424(c)(3)(A) of the code under the bill as amended by your committee)), for any reason connected with his employment by the corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if the requirements of paragraphs (1) through (7) of section 422(b) are met.

Your committee has amended this provision by changing the date contained therein from June 11, 1963, to December 31, 1963.

(*b*) *Special rules.*—

Certain options treated as outstanding

Under the bill as passed by the House, section 422(c)(2) of the code provided that, for purposes of section 422(b)(5) (relating to prior outstanding options)—

(A) any restricted stock option which is not terminated before January 1, 1965, and

(B) any qualified stock option granted after June 11, 1963,

shall be treated as outstanding until such option is exercised in full or expires by reason of the lapse of time. The bill as passed by the House further provided that for purposes of the preceding sentence, a restricted stock option granted before June 12, 1963, shall not be treated as outstanding for any period before the first day on which (under the terms of the option) it may be exercised.

Your committee has amended this provision by changing the dates June 11, 1963, and June 12, 1963, contained therein to December 31, 1963, and January 1, 1964, respectively.

Certain disqualifying dispositions where amount realized is less than value at exercise

Under the bill as passed by the House, section 422(c)(4) of the code provided that if an individual who has acquired a share of stock by the exercise of a qualified stock option disposes of such share within 3 years of the transfer of such share to him and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then the amount includible in the gross income of such individual, and deductible from the income of his employer corporation, as compensation attributable to the exercise of such option cannot exceed the excess, if any, of the amount realized on such sale or exchange over the amount paid for such share.

Your committee has amended this provision in order to provide that the amount of compensation recognized to the individual, or deductible from the income of his employer corporation, is to be limited to the excess, if any, of the amount realized on such sale or exchange over the adjusted basis of such share. Thus, your committee's amendment changes the effect of this provision as passed by the House only if the adjusted basis of the share differs from the amount paid for the share, as might result in the case of the exercise of an option to which section 422(c)(1) (relating to exercise of option when price is less than value of stock) applies.

Exception to application of subsection (b)(5)

Under the bill as passed by the House, paragraphs (1) through (5) of section 422(c) of the code contained five special rules relating to qualified stock options. Your committee has amended section 422(c) by adding a new paragraph (6) at the end thereof. The new section 422(c)(6) (relating to exception to application of subsec. (b)(5)) provides, in effect, that a new qualified stock option being granted to an individual need not contain the limitation on exercise otherwise required by section 422(b)(5), if the new option and all the outstanding qualified (or restricted) stock options previously granted to the individual, are options to purchase stock of the same class in the same corporation, and if the price payable under each such outstanding option (determined as of the date of grant of the new qualified stock option being granted to the individual) is not more than the option price of the option being granted.

The operation of the new paragraph (6) of section 422(c) is illustrated by the following examples:

Example (1).—Assume that on January 2, 1964, A, an employee of M corporation, is granted a qualified stock option entitling him to

purchase 100 shares of M stock at a price of $5 per share (the fair market value of M stock on such date). On June 2, 1964, M grants A another qualified stock option with respect to the same class of stock as the January option, entitling him to buy 100 shares of such stock at a price of $6 per share (the fair market value of such stock on such date).

Under the bill as passed by the House, the option granted A in June must contain a provision that such option is not exercisable until the option granted in January has either been exercised in full, or has lapsed. Under the bill as amended by your committee, the June option may be exercisable before the January option since both options are to purchase the same class of stock in the same corporation and the option price of the January option ($5) is not greater than the option price of the June option ($6).

Example (2).—The facts are the same as in example (1) except that the option price of the June option is $4, the fair market value of the stock on June 2, 1964. The new rule of section 422(c)(6) (relating to exception to the application of sec. 422(b)(5)) is not applicable in this case since the price payable for the stock under the January option ($5) is greater than the option price of the June option ($4). Similarly, the exception to the application of section 422(b)(5) provided by the new section 422(c)(6) would not be applicable if the June option were granted with respect to a different class of M stock, or with respect to the stock of a parent or subsidiary of M corporation. In such a situation, the provisions of section 422(b)(5) remain applicable and the outstanding option must either be exercised in full or lapse before the more recently granted option may become exercisable.

SECTION 423. EMPLOYEE STOCK PURCHASE PLANS

(*a*) *General rule*.—Under the bill as passed by the House, section 423(a) of the code provided that the special tax treatment of the new section 421(a) shall apply to a transfer of a share of stock to an individual pursuant to his exercise of an option, if the option is granted after June 11, 1963 (other than a restricted stock option granted pursuant to a plan described in sec. 424(c)(4)(B) (sec. 424(c)(3)(B) of the code under the bill as amended by your committee)), under an employee stock purchase plan (as defined in sec. 423(b)), and if the holding period and employment requirements set forth in paragraphs (1) and (2) of section 423(a) are met.

Your committee has amended this provision by changing the date contained therein from June 11, 1963, to December 31, 1963.

SECTION 424. RESTRICTED STOCK OPTIONS

(*a*) *Restricted stock option*.—Under the bill as passed by the House, section 424(b) of the code continued the definition of the term "restricted stock option" presently contained in section 421(d)(1) for options granted before June 12, 1963 (or after June 11, 1963, if granted in accordance with sec. 424(c)(4) (sec. 424(c)(3) of the code under the bill as amended by your committee)).

Your committee has amended this provision by changing the dates contained therein from June 12, 1963, to January 1, 1964, and from June 11, 1963, to December 31, 1963.

(*b*) *Special rules.*—Under the bill as passed by the House, section 424(c) of the code provided three special rules relating to restricted stock options, all of which are identical to provisions of existing section 421, and a fourth special rule relating to certain options granted after June 11, 1963. Your committee has amended these special rules in the following respects:

Stockholder approval

Under the bill as passed by the House, the applicability of section 424(c)(2) of the code (relating to stockholder approval) was limited to restricted stock options. Your committee has extended the rule contained in section 424(c)(2) to qualified stock options and options granted under employee stock purchase plans by striking paragraph (2) of section 424(c), and by inserting a comparable provision as subsection (i) under section 425 (relating to definitions and special rules). A technical explanation of the new section 425(i) may be found, in place, below.

Certain options granted after December 31, 1963

Under the bill as passed by the House, paragraph (4) of section 424(c) of the code (sec. 424(c)(3) of the code under the bill as amended by your committee) provided the additional requirements that must be met by options granted after June 11, 1963, in order for such options to be treated as restricted stock options. In general, under the bill as passed by the House, an option granted after June 11, 1963, that otherwise meets the requirements of the new section 424(b) of the code is treated as a restricted stock option for purposes of the revised part II of subchapter D if it was granted pursuant to—

(A) a binding written contract entered into before June 12, 1963, or

(B) a written plan adopted and approved before June 12, 1963, which (as of June 12, 1963, and as of the date of the granting of the option) either met the requirements of paragraphs (4) and (5) of section 423(b) or was being administered in a way that did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

Your committee has amended this provision by changing the dates contained therein from June 11, 1963, to December 31, 1963, and from June 12, 1963, to January 1, 1964. In determining whether an option is granted pursuant to a plan described in subparagraph (B) of the provision, the terms of any written offering that was made on or before January 1, 1964, will be treated as a part of the plan.

SECTION 425. DEFINITIONS AND SPECIAL RULES

(*a*) *Modification, extension, or renewal of option.*—

Special rules for sections 423 and 424 options

Under the bill as passed by the House, subparagraph (B) of section 425(h)(2) of the code continues the rule of the existing section 421(e)(1) that provides an exception to the rule of section 425(h)(2)(A) if the average fair market value of the stock for the 12 months prior to the modification, extension, or renewal is less than 80 percent of the fair market value at the date of the original granting or any intervening

modification, extension, or renewal, whichever is higher. Under the bill as passed by the House, this exception only applies to modifications, extensions, or renewals of restricted stock options made before June 12, 1963 (or made pursuant to a binding written contract entered into before June 12, 1963).

Your committee has amended this provision by changing the date contained therein from June 12, 1963, to January 1, 1964.

Definition of modification

Under the bill as passed by the House, paragraph (3) of section 425(h) of the code defined the term "modification" in the same manner as existing section 421(e). Thus, under the bill as passed by the House, the term "modification" was defined as any change in the terms of the option which gives the employee additional benefits; but such term does not include a change in the terms of the option which is attributable to the issuance or assumption of an option under section 425(a), or to permit the option to qualify under section 422(b)(6), 423(b)(9), or 424(b)(2) if, in the case of a restricted stock option, the period during which the option may be exercised is restricted to 10 years from the date of the grant of the option.

Your committee has amended this provision by adding a new subparagraph (C) to section 425(h)(3) as set forth in the bill as passed by the House. The new subparagraph (C) added by your committee provides an additional exception to the definition of the term "modification." This new exception provides that a change in the terms of an option which is not immediately exercisable in full to accelerate the time at which the option may be exercised is not a modification for purposes of section 425(h). Thus, your committee's amendment allows an option which is exercisable only in installments, or after the expiration of a fixed period of time, or on the happening of an event, to be amended to permit acceleration of the time for exercising any (or all) of the installments, or to permit an acceleration in the time for exercising all or any portion of the option, without treating such amendment as a modification of the option.

(*b*) *Stockholder approval.*—Under the bill as passed by the House, paragraph (2) of section 424(c) of the code provided that for purposes of section 424 (relating to restricted stock options), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. Thus, under the bill as passed by the House, the applicability of section 424(c)(2) was limited to restricted stock options.

Your committee has extended the rule of section 424(c)(2) to qualified stock options and options granted under employee stock purchase plans by striking paragraph (2) of section 424(c) as set forth in the bill as passed by the House, by redesignating section 425(i) (relating to cross references) as section 425(j) and by inserting a new section 425(i). The new section 425(i) provides that for purposes of part II of subchapter D of chapter 1 of the code (relating to certain stock options), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

SECTION 222. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS—Continued

(*b*) *Administrative provisions.*—Subsection (b) of this section of the bill as passed by the House has been amended by your committee as follows:

Penalties for failure to file information returns

Subsection (b)(2) of this section of the bill as passed by the House amends section 6652(a) of the code (relating to failure to file certain information returns) to provide a penalty for the failure to file the return required by section 6039(a). Your committee has revised section 6652 as amended by the bill as passed by the House in order to make clear that the penalty provided under section 6652(a) is imposed for each failure to file the statement referred to in section 6652(a)(1), and for each failure to file a return with respect to a transfer referred to in section 6652(a)(2). Thus a penalty is incurred under section 6652(a)(2) with respect to each transfer described in the new section 6039 which the taxpayer fails to report on the return required by such section. The penalty is $10 for each such failure, not to exceed $25,000 for all failures described in section 6652(a) in any one calendar year.

Your committee has also amended section 6652(a) of the code to provide that the penalty provided by such section shall be imposed in the case of each failure to make a return required by section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance) with respect to group-term life insurance on the life of an employee. (The new sec. 6052 is added to the code by sec. 204 of the bill as reported by your committee.)

(*c*) *Effective date.*—Subsection (e) of this section of the bill as passed by the House provided that the amendments made by this section apply to taxable years ending after June 11, 1963; except that the new section 6039 of the code added by subsection (b) of this section (relating to administrative provisions), and paragraph (2) of section 6652(a) of the code as amended by such subsection, apply only to stock transferred pursuant to options exercised on or after January 1, 1964.

Your committee has amended subsection (e) of this section of the bill as passed by the House by changing the general effective date of the provisions relating to employee stock options and purchase plans as passed by the House from June 11, 1963, to December 31, 1963, and by adding a special rule for certain options granted after December 31, 1963, and before January 1, 1965. The special rule is contained in a new paragraph (3) added to subsection (e) of this section of the bill as passed by the House. The new paragraph provides that paragraphs (1) and (2) of section 422(b) of the code shall not apply to an option granted after December 31, 1963, and before January 1, 1965, and that paragraph (1) of section 425(h) shall not apply to any change in the terms of such an option made before January 1, 1965, to permit the option to qualify under paragraphs (3), (4), and (5) of section 422(b).

Subparagraph (A) of the new paragraph (3) permits the transfer of a share of stock pursuant to an individual's exercise of a stock option granted after December 31, 1963, and before January 1, 1965, to

qualify for the special tax treatment provided by the revised section 421 of the code without regard to whether the option is granted pursuant to a plan, as required by section 422(b)(1), or whether the plan was approved by the shareholders. In addition, since the option need not be granted pursuant to a plan at all, the option need not be granted within 10 years from the date such plan is adopted or approved, whichever is earlier, as provided under section 422(b)(2).

Subparagraph (B) of paragraph (3) allows options granted after December 31, 1963, and before January 1, 1965, to be amended at any time before January 1, 1965, to meet the requirements of paragraphs (3), (4), and (5) of section 422(b), without such amendments being treated as a modification under section 425(h). Amendments to options under subparagraph (B) of paragraph (3) are to be retroactive to the date of grant of the option.

SECTION 223. INSTALLMENT SALES BY DEALERS IN PERSONAL PROPERTY

Section 223 of the bill, which was added by your committee to the bill as passed by the House, amends section 453(a) of the code (relating to the reporting of income by dealers in personal property from sales on the installment plan).

(*a*) *Installment plans.*—Subsection (a) of section 223 amends section 453(a) of the code by placing the existing provisions thereof in a new paragraph (1) of such subsection and by adding new paragraphs (2) and (3). The new paragraph (2) provides that for purposes of determining whether a dealer in personal property is selling such property on the installment plan so that he may return on the installment method (as described in par. (1)) the income from such sales, the term "installment plan" includes any plan which provides that the purchaser is to pay for such sales in a series of periodic installments of the debt due such dealer.

Paragraph (3) of revised section 453(a) provides that for purposes of computing the income from sales of personal property to be reported on the installment method by a dealer in personal property under paragraph (1), the term "total contract price" includes all charges relative to such sales including the time price differential which represents the amount paid or payable by the purchaser for the privilege of paying for such property in installments. Charges relative to the sale of personal property do not include charges for service contracts or warranties, or other charges for services unless such services are incidental to and rendered contemporaneously with the sale of the personal property.

(*b*) *Effective date.*—Subsection (b) of section 223 provides that the amendment made by subsection (a) of such section shall apply to taxable years beginning after December 31, 1963.

SECTION 224. TIMING OF DEDUCTIONS AND CREDITS IN CERTAIN CASES WHERE ASSERTED LIABILITIES ARE CONTESTED

Section 224 of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code (relating to general rule for taxable year of deduction) and section 43

of the 1939 Code (relating to period for which deductions and credits taken), and provides certain transitional rules. No provision of this section of the bill extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

(*a*) *Taxable year of deduction or credit.*—Paragraph (1) of section 224(a) of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code, relating to general rule for taxable year of deduction, by adding to such section a new subsection (f). In G.C.M. 25298, 1947–2 C.B. 39, the Internal Revenue Service took the position that a taxpayer may deduct the amount of taxes paid to local authorities not later than for the year of payment even though he contests liability for such taxes. In 1961, the U.S. Supreme Court held that, where an accrual basis taxpayer contested taxes paid to local authorities, the contested amount was deductible for the taxable year in which the contest was settled rather than for the taxable year in which such amount was paid (*U.S.* v. *Consolidated Edison Co.* (1961) 366 U.S. 380). The new subsection (f), in the case of contested taxes, provides that the contested amount is deductible for the year of payment.

The new subsection (f) provides in effect that if (1) a taxpayer contests an asserted liability (such as a tax assessment); (2) such taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of the transfer; and (4) but for the fact that the asserted liability is contested, a deduction or credit would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable), then the deduction or credit shall be allowed for the taxable year of the transfer.

The new subsection (f) is not limited to an asserted liability for taxes, but applies to any asserted liability where the requirements of the new subsection (f) are met. A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an escrow agent provided that the money or other property is beyond the control of the taxpayer. However, purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, or a transfer to an account which is within the control of the taxpayer is not a transfer to provide for the satisfaction of an asserted liability.

The new subsection (f) applies only if the contest with respect to the asserted liability exists after the time of payment. Thus, the new subsection (f) does not apply to Z corporation in the following example:

Example.—Z corporation uses the accrual method of accounting. In 1964 a $100 liability is asserted against Z. Z contests the asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80.

If any portion of the contested amount, which is deducted in the year of payment, is refunded when the contest is settled, such portion is includible in gross income except as provided in section 111 of the 1954 Code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

The new subsection (f) may be illustrated by the following examples:

Example (1).—X corporation, which uses the cash method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 X deducts $100 and for the taxable year 1968 X includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Example (2).—Y corporation, which uses the accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 Y deducts $100 and for the taxable year 1968 Y includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Paragraph (2) of section 224(a) of the bill, as added by your committee, amends section 43 of the 1939 Code, relating to period for which deductions and credits taken, by adding at the end of such section a new sentence. The new sentence is the same as the new subsection (f) added to section 461 of the 1954 Code by paragraph (1) of section 224(a) of the bill.

(*b*) *Effective dates*.—Subsection (b) of section 224 of the bill, as added by your committee, provides that except as provided in subsections (c) and (d) of section 224 of the bill—

(1) the new subsection (f) of section 461 of the 1954 Code, as added by paragraph (1) of section 224(a) of the bill, shall apply to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, and

(2) the new sentence added to section 43 of the 1939 Code by paragraph (2) of section 224(a) of the bill shall apply to transfers of money or other property in taxable years to which the Internal Revenue Code of 1939 applies.

(*c*) *Election as to transfers in taxable years beginning before January 1, 1964*.—Paragraph (1) of section 224(c) of the bill, as added by your committee, provides that the amendments made to section 461 of the 1954 Code and section 43 of the 1939 Code by paragraphs (1) and (2), respectively, of section 224(a) of the bill shall not apply to any transfer of money or other property described in such section 224(a) made in a taxable year beginning before January 1, 1964, if the taxpayer elects, in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, to have such paragraph (1) apply. Such an election (1) must be made within 1 year after the date of enactment of the bill, (2) may not be revoked after the expiration of such 1-year period, and (3) shall apply to all transfers of money or other property described in section 224(a) of the bill made in a taxable year beginning before January 1, 1964 (other than transfers described in par. (2) of sec. 224(c) of the bill). In the case of any transfer to which paragraph (1) of section 224(c) of the bill applies, the deduction or credit shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

Paragraph (2) of section 224(c) of the bill, as added by your committee, provides that paragraph (1) of such section 224(c) shall not

apply to any transfer if the assessment of any deficiency which would result from the application of the election in respect of such transfer is, on the date of the election under such paragraph (1), prevented by the operation of any law or rule of law.

Paragraph (3) of section 224(c) of the bill, as added by your committee, provides that if the taxpayer makes an election under paragraph (1) of section 224(c) of the bill, and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or rule of law, the period within which assessment of such deficiency may be made shall not expire earlier than 2 years after the date of enactment of this bill.

(*d*) *Certain other transfers in taxable years beginning before January 1, 1964.*—Subsection (d) of section 224 of the bill, as added by your committee, provides that the amendments made to section 461 of the 1954 Code and section 43 of the 1939 Code by paragraphs (1) and (2), respectively, of section 224(a) of the bill shall not apply to any transfer of money or other property described in such section 224(a) made in a taxable year beginning before January 1, 1964, if (1) no deduction or credit has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and (2) refund or credit of any overpayment which would result from the application of such amendments to such transfer is prevented by the operation of any law or rule of law. In the case of any transfer to which subsection (d) of section 224 of the bill applies, the deduction or credit shall be allowed only for the taxable year in which the contest with respect to such transfer is settled. Thus, if, at any time when a refund or credit of any overpayment, which would result from the application of the new subsection (f) of section 461 of the 1954 Code to a transfer of money or other property described in such new subsection (f) made in a taxable year beginning before January 1, 1964, is prevented by the operation of any law or rule of law, no deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, then a deduction shall be allowed to the taxpayer for the taxable year in which such contest is settled.

SECTION 225. INTEREST ON CERTAIN DEFERRED PAYMENTS

Section 225 of the bill (sec. 215 of the bill as passed by the House) has been approved by your committee with two modifications. For the technical explanation of this section of the bill (other than the amendments made by your committee), see the report of the Committee on Ways and Means starting at page 332.

Your committee has deleted subsection (c) of this section of the bill as passed by the House, which related to deduction as interest of certain carrying charges on certain sales of services.

Under subsection (c) of this section (subsec. (d) of the bill as passed by the House) relating to effective dates, the amendments made by subsections (a) and (b) of section 225 apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. Your committee's amendment provides that the amendments made by subsections (a) and (b) will not

be applicable to payments made on account of a sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963. Thus, if before such date a taxpayer has committed himself to a sale or exchange of property either by entering into a binding written sales contract or by granting an irrevocable written option entitling another person to purchase the property, any sale or exchange made pursuant to such contract or option will not be affected by the rules of new section 483.

SECTION 226. PERSONAL HOLDING COMPANIES

Section 226 of the bill (sec. 216 of the bill as passed by the House) deals with the treatment of personal holding companies and shareholders of such companies. This section of the bill as passed by the House consisted of 12 subsections, designated (a) through (l). Your committee has adopted the following subsections of this section without change: (a) relating to the personal holding company tax rate, (b) relating to the definition of a personal holding company, (e) relating to foreign personal holding company income and stock ownership, (f) relating to the dividends-paid deduction, and (h) relating to an exception for certain liquidated corporations. Your committee has rejected in its entirety subsection (j), relating to an increase in basis with respect to certain foreign personal holding company holdings, of the bill as passed by the House, has redesignated subsections (k) and (l), respectively, as subsection (j) relating to technical amendments, and subsection (k) relating to effective dates, and has made some technical amendments in redesignated subsection (k) to reflect this elimination.

The changes made by your committee in remaining subsections (c), (d), (g), and (i) of this section are discussed below. For the technical explanation of this section (other than the amendments made by your committee), see page 336 of the report on the bill by the Committee on Ways and Means.

Section 226(c), relating to excluded corporations

Subsection (c) of section 226 of the bill has been approved by your committee with four modifications. For the technical explanation of subsection (c) of the bill (except for the amendments explained below), see page 337 of the report on the bill by the Committee on Ways and Means.

Under the bill as passed by the House, a lending or finance company is excluded from the definition of a personal holding company if it meets four requirements: (1) At least 60 percent of its ordinary gross income must be derived directly from the active and regular conduct of a lending or finance business; (2) its personal holding company income (computed (a) without regard to income qualifying under the 60-percent test, (b) by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for the use of corporate property by shareholders, and (c) without regard to certain income from domestic subsidiaries described in sec. 542(d)(3) of the code), plus the interest described in section 543(b)(2)(C) of the code, must not exceed 20 percent of ordinary gross income; (3) business deductions directly allocable to the active and regular conduct of its lending or finance business must equal or exceed the sum of (i) 15

percent of its ordinary gross income up to $500,000, plus (ii) 5 percent of its ordinary gross income between $500,000 and $1,000,000; and (4) loans to substantial shareholders must not exceed $5,000 in principal amount.

In applying the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B), your committee has deleted the provision that interest described in section 543(b)(2)(C) be included with the corporation's personal holding company income. This change conforms the treatment of such interest under section 542(c)(6)(B) to the treatment thereof for all other personal holding company tax purposes.

Under the bill as passed by the House, section 542(d)(3) of the code provides that the lawful income received by a lending company which is in the small loan business (consumer finance business) from domestic subsidiary corporations which are themselves excepted from the definition of a personal holding company under section 542(c)(6), is not included for purposes of the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B). Your committee has amended this provision in two respects. First, the corporation receiving such income may be any lending or finance company which meets the 60-percent requirement of section 542(c)(6)(A). It does not have to meet the more restrictive requirement of being in the small loan (consumer finance) business. Second, the payor corporation may be any member of the same affiliated group (as defined in sec. 1504) as the corporation receiving such income. Thus the corporation receiving such income is not required to be the parent corporation of the payor corporation. The payor corporation must still meet the requirements of section 542(c)(6).

Under the bill as passed by the House, section 542(d)(1)(A) of the code defines a lending or finance business, generally, as a business of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations.

Your committee has amended the definition of a lending or finance business in section 542(d)(1) to include therein the business of rendering services or making facilities available to another member of the same affiliated group (as defined in sec. 1504) that is also in the lending or finance business.

Under the 60-percent-of-ordinary-gross-income test provided in section 542(c)(6)(A) of the code the corporation's income must be derived "directly" from the active and regular conduct of a lending or finance business. In addition, a reference to this provision is made in section 542(c)(6)(B). The use of the term "directly" is intended to emphasize that the 60-percent test is limited to income "derived from the active and regular conduct" of a lending or finance business, and excludes income that is unrelated to the conduct of the lending or finance business itself. Thus, for example, under section 542(c)(6)(A) as approved by your committee, interest income earned by the lending or finance company from loans to customers would qualify under the 60-percent test, but interest earned from the investment of its idle funds in short-term securities would not qualify under the 60-percent test.

The phrase "directly allocable to the active and regular conduct of its lending or finance business" is used in section 542(c)(6)(C) (business expense test) and, with a minor difference in language, in section 542(d)(2)(B) (relating to deductions for depreciation and real property

taxes). As used in these provisions, the term "directly" is intended to exclude expenses unrelated to the conduct of the finance or lending business. It is not intended to exclude completely deductions allocable only in part to such business. Thus, for example, to the extent that general overhead expenses of a corporation are properly allocable to the lending and finance business, they qualify as business deductions under section 542(d)(2).

Section 226(d), relating to personal holding company income

Subsection (d) of section 226 of the bill amends section 543(a) of the code (relating to personal holding company income). It also amends section 543(b) to provide definitions of the new terms "ordinary gross income," "adjusted ordinary gross income," "adjusted income from rents," and "adjusted income from mineral, oil, and gas royalties."

The amended section 543(a) provides that for purposes of subtitle A, the term "personal holding company income" means the portion of the adjusted ordinary gross income (as defined in sec. 543(b)(2)) which consists of the items described in paragraphs (1) through (8) of such section.

Your committee has approved subsection (d) of section 226 of the bill except for changes in paragraph (2) of section 543(a) as amended (relating to rents), in subparagraph (A) of section 543(b)(2) as amended (relating to required adjustments in the amount of gross income from rents includible in adjusted ordinary gross income), and in paragraph (4) of section 543(b) as amended (defining "adjusted income from mineral, oil, and gas royalties").

Rents

Section 543(a)(7) of existing law provides that rents are personal holding company income unless such rents constitute 50 percent or more of gross income.

The bill as passed by the House provides in paragraph (2) of section 543(a) as amended, which corresponds to the existing section 543(a)(7), that only so much of the gross income from rents as is equal to the adjusted income from rents (as defined in sec. 543(b)(3)) is personal holding company income and that the adjusted income from rents shall not be treated as personal holding company income if (A) it constitutes 50 percent or more of the corporation's adjusted ordinary gross income (as defined in sec. 543(b)(2)), and (B) the corporation's personal holding company income for the taxable year, computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating copyright royalties and adjusted income from mineral, oil, and gas royalties as personal holding company income, is not more than 10 percent of the ordinary gross income as defined in section 543(b)(1). Thus, under the bill as passed by the House, even though adjusted income from rents constitutes more than 50 percent of a corporation's adjusted ordinary gross income, this income will still be treated as personal holding company income if the corporation's other income which is classified as personal holding company income exceeds 10 percent of its total ordinary gross income. For examples and the technical explanation of these tests in the bill (except for the amendment made by your committee), see page 341 of the report on the bill by the Committee on Ways and Means.

Your committee has modified the 10-percent test in subparagraph (B) of section 543(a)(2) in the bill passed by the House to provide that adjusted income from rents which meets the 50-percent requirement of subparagraph (A) thereof shall not be treated as personal holding company income if the sum of the consent dividends (determinded under sec. 565) and the dividends paid or considered as paid (determined under secs. 562 and 563) during the taxable year by the corporation to its shareholders equals or exceeds the amount, if any, by which the corporation's personal holding company income for the taxable year, computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating copyright royalties and adjusted income from mineral, oil, and gas royalties as personal holding company income, exceeds 10 percent of the ordinary gross income as defined in section 543(b)(1).

The effect of this modification in the 10-percent test applicable to rents is that this test shall be deemed to be met if the corporation pays dividends to its shareholders in an amount which is at least equal to its other personal holding company income which is in excess of 10 percent of total ordinary gross income. The difference in this test in the bill as passed by the House and as modified by your committee may be illustrated by the following example:

Example.—Corporation F receives $40 in dividends and $150 of gross income from rents. Corporation F also realizes $10 in capital gain on the sale of securities. Corporation F's deductions for depreciation, interest, and real property taxes allocable to the rents equal $100. Under existing law the rents are not personal holding company income and corporation F is not a personal holding company, since its gross income from rents ($150) constitutes 50 percent or more of its gross income ($200). Under the 50-percent requirement of the new provisions, the adjusted income from rents, $50 ($150 less $100), is 55.5 percent of adjusted ordinary gross income of $90 ($200 less the sum of $100 of adjustments and $10 of capital gains). Accordingly the adjusted income from rents meets the new 50-percent requirement. However, other personal holding company income (the dividend income of $40) is $21 in excess of the allowable 10 percent of ordinary gross income ($190: $200 less $10). Under the bill as passed by the House, the adjusted income from rents is personal holding company income and, therefore, all of corporation F's adjusted ordinary gross income is personal holding company income. However, with the modification in the 10-percent test made by your committee, the adjusted income from rents would not be treated as personal holding company income if corporation F pays a dividend of $21 to its shareholders during the taxable year. On the other hand, if the amount of the dividend paid by corporation F is less than $21, the adjusted income from rents would be personal holding company income as under the bill as passed by the House.

Adjustments to rents included in adjusted ordinary gross income

The bill as passed by the House defines in paragraph (2) of section 543(b) of the code, as amended, the term "adjusted ordinary gross income" as the ordinary gross income adjusted as provided in subparagraphs (A), (B), and (C) of such paragraph. Adjusted ordinary gross income as so defined replaces the concept of gross income of

existing law as the denominator in the fraction used in computing certain percentages involved in determining a corporation's status as a personal holding company. With one exception relating to the adjustments required for gross income from rents, your committee has approved proposed section 543(b)(2). For the technical explanation of these provisions of the bill (except the amendment explained below), see page 348 of the report on the bill by the Committee on Ways and Means.

Subparagraph (A) of section 543(b)(2) provides that from the gross income from rents (as defined in the second sentence of sec. 543(b)(3)) there is to be subtracted the amounts allowable as deductions for exhaustion, wear and tear, obsolescence, and amortization as well as deductions for property taxes, interest, and rent to the extent that such deductions are allocable, under regulations prescribed by the Secretary of the Treasury or his delegate, to the gross income from rents. In no case may the amounts subtracted under subparagraph (A) exceed the gross income from rents.

Your committee has amended subparagraph (A)(i) of section 543(b)(2) to provide that the gross income from rents derived from leases of tangible personal property which is not customarily retained by any one lessee for a period of more than 3 years shall not be reduced by allowable deductions for exhaustion, wear and tear, obsolescence, and amortization of such property. It is the period of customary retention or use by lessees, rather than the term of the lease of the property in any one case, which is determinative of whether the adjustment shall be required.

Adjusted income from mineral, oil, and gas royalties

The bill as passed by the House provides in paragraph (3) of section 543(a) of the code as amended, which corresponds to section 543(a)(8) of existing law, tests for determining whether the "adjusted income from mineral, oil, and gas royalties", as defined in paragraph (4) of section 543(b), is personal holding company income. For the technical explanation of these provisions (except the amendment explained below), see page 343 of the report on the bill by the Committee on Ways and Means. These provisions have been approved by your committee but an amendment has been added to section 543(b)(4) to specifically include production payments and overriding royalties as mineral, oil, and gas royalties for purposes of classification as personal holding company income under section 543(a).

The Treasury regulations interpreting section 543(a)(8) of existing law currently define the term "mineral, oil, or gas royalties" as including production payments and overriding royalties. (See Reg. § 1.543–1(b)(11)(ii).) However, it has been brought to the attention of your committee that this interpretation of existing section 543(a)(8) is disputed by some taxpayers. Your committee's amendment would make it clear that production payments and overriding royalties are to be treated as mineral, oil, and gas royalties under proposed section 543(b)(4). This amendment is not intended to affect any case involving interpretations of section 543(a)(8) of existing law.

Section 226(g), relating to 1-month liquidations

Subsection (g) of section 226 of the bill adds a new subsection (g) to section 333 of the code. The existing section 333 provides that in certain corporate liquidations gain is recognized to qualified electing

shareholders only to the extent of earnings and profits accumulated by the corporation after February 28, 1913, and cash, stock, and securities acquired by the corporation after December 31, 1953, and, with respect to accumulated earnings and profits, is taxable as a dividend to noncorporate shareholders.

Subsection 333(g) as added by the bill as passed by the House consists of three paragraphs. Paragraph (1) provides that if a corporation which is referred to in paragraph (3) of the new subsection is liquidated before January 1, 1966, no gain will be recognized to a qualifying electing shareholder with respect to the distribution of stock and securities acquired by the liquidating corporation before January 1, 1963, and gain realized by a noncorporate shareholder with respect to the corporation's accumulated earnings and profits generally is to be treated as "class B capital gain" rather than as a dividend. Paragraph (2) of subsection (g) provides special rules for liquidations after December 31, 1965, of corporations referred to in paragraph (3) of the new subsection which owe qualified indebtedness (as defined in sec. 545(c)(3)) on August 1, 1963. Paragraph (3) of subsection (g) describes the corporations to which paragraphs (1) and (2) of section 333(g) may apply. Such a corporation in the bill as passed by the House is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before the date of enactment of section 333(g), but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

Your committee has approved in substance the provisions of paragraphs (1), (2), and (3) of section 333(g) as added by the bill as passed by the House but has modified some of the applicable dates therein and has added a new paragraph (4) to new section 333(g) of the code. These modifications and new paragraph (4) of section 333(g) are discussed below. For the technical explanation of section 226(g) of the bill (except for the amendments made by your committee), see page 355 of the report on the bill by the Committee on Ways and Means.

Your committee has amended paragraph (1) of section 333(g) to provide that it shall be applicable to corporate liquidations occurring before January 1, 1967 (instead of January 1, 1966) and has amended paragraph (2) of section 333(g) to provide that it shall be applicable to liquidations occurring after December 31, 1966 (instead of Dec. 31, 1965) of corporations which owe qualified indebtedness (as defined in sec. 545(c)) on January 1, 1964 (instead of Aug. 1, 1963). Your committee has made conforming amendments in these two paragraphs of section 333(g) to reflect these changes and also changes made in other parts of the bill as approved by your committee.

Your committee has amended paragraph (3) of section 333(g), which describes the corporations to which paragraphs (1) and (2) of the new subsection may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before December 31, 1963 (instead of the date of enactment of new subsec. (g)) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first

taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

Your committee has added a new paragraph (4) to subsection (g) of section 333 which provides that if an election is made under such section by a qualified electing shareholder (as defined in sec. 333(c)) of a corporation and the shareholder states in such election that it is made on the assumption that the corporation is a corporation referred to in paragraph (3) of subsection (g), the election under section 333 shall have no force or effect if it is determined that the corporation is not a corporation referred to in section 333(g)(3). A qualified electing shareholder who does not include such a statement in an election made and filed under section 333 will be considered to have made an election under the general rule of subsection (a) of such section with respect to recognition of gain on the shares owned by him in the liquidating corporation in the event that the special rule of subsection (g) is inapplicable because the corporation is not a corporation referred to in paragraph (3) thereof.

Section 226(i), relating to deduction for amortization of indebtedness

Subsection (i) of section 226 of the bill adds a new subsection (c) to section 545 of the code which provides a new deduction from taxable income for purposes of determining undistributed personal holding company income (as defined in sec. 545(a)).

Section 545(c) of the code as added by subsection (i) consists of six paragraphs. Paragraph (1) of the new section 545(c) provides the general rule that, except as otherwise provided in such section, there shall be allowed as a deduction (in computing undistributed personal holding company income) amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness (as defined in sec. 545(c)(3)). Paragraph (2) describes the corporations which may qualify for the deduction provided in paragraph (1) of section 545(c). Paragraph (3) defines the term "qualified indebtedness," subject to certain exceptions, as the outstanding indebtedness incurred by the taxpayer after December 31, 1933, and before August 1, 1963, and the outstanding indebtedness (if not otherwise deducted) incurred after July 31, 1963, for the purpose of making a payment or set-aside referred to in section 545(c)(1) in the same taxable year. Paragraph (4) provides that a corporation may elect to treat as nondeductible an amount otherwise deductible under paragraph (1) of section 545(c). Paragraph (5) provides certain limitations on the amount of the deduction otherwise allowed by section 545(c)(1). Paragraph (6) provides that the total amounts of the taxpayer's qualified indebtedness (as defined in sec. 545(c)(3)(A)) are reduced if property (of a character which is subject to the allowance for exhaustion, wear and tear, obsolescence, or amortization) is disposed of after July 31, 1963.

Your committee has approved in substance the provisions of subsection (i) of the bill as passed by the House. For the technical explanation of subsection (i) of the bill, other than the amendments explained below, see page 361 of the report on the bill by the Committee on Ways and Means. However, your committee has amended paragraph (3) of proposed section 545(c) to provide that the term "qualified indebtedness" shall include the outstanding indebtedness incurred by the taxpayer before January 1, 1964, and has made conforming amendments in the other paragraphs of section 545(c).

Your committee has also amended paragraphs (5) and (6) of section 545(c) to provide that allowable deductions for depletion shall be taken into account to reduce the deduction allowed by section 545(c) and qualified indebtedness under certain circumstances. Your committee has also amended paragraph (2)(A) of section 545(c), which describes a category of corporations to which paragraph (1) of the new subsection may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before December 31, 1963 (instead of the date of enactment of this subsection) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

SECTION 227. TREATMENT OF PROPERTY IN CASE OF OIL AND GAS WELLS

Section 227 of the bill (sec. 217 of the bill as passed by the House) has been approved by your committee without change. For the technical explanation of this section of the bill, see page 370 of the report of the Committee on Ways and Means on the bill.

SECTION 228. TREATMENT OF CERTAIN IRON ORE ROYALTIES

(*a*) *In general.*—Subsection (a) of section 228 of the bill (sec. 218 of the bill as passed by the House) has been approved by your committee except that your committee has (1) restricted its application to iron ore mined in the United States, and (2) provided that the treatment provided by the bill shall not apply to any disposal of iron ore to certain related persons. For the technical explanation of section 228(a) of the bill (other than the amendments made by your committee), see page 381 of the report of the Committee on Ways and Means on the bill.

Under your committee's amendments two types of dispositions of iron ore to related persons will not qualify for treatment under section 631(c) of the code. The first type of such disposition occurs in any disposal to a person whose relationship to the party disposing of such iron ore is such that a loss would be disallowed under section 267 (relating to losses, etc., with respect to transactions between related taxpayers) or section 707(b) (relating to certain sales or exchanges of property with respect to controlled partnerships). Thus, iron ore royalty payments made under a lease between a father and his son would not qualify for treatment under section 631(c). The second type of such disposition occurs in any disposal to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore. The test for determining the presence or absence of control is the same test as is presently applied in section 482 of the code (relating to the allocation of income and deductions between taxpayers).

(*b*) *Clerical amendments.*—Subsection (b) of section 228 of the bill contains the various clerical and conforming amendments to the code and to the Social Security Act which are required as a result of the amendments made by subsection (a) of such section.

(*c*) *Effective date.*—Subsection (c) of this section as passed by the House provided that the amendments made by such section shall apply to iron ore mined in taxable years beginning after December 31, 1963. Your committee has amended this subsection to provide that such amendments shall apply to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

SECTION 229. INSURANCE COMPANIES

Section 229 of the bill, which is a new section added to the bill as passed by the House, contains amendments to subchapter L of chapter 1 of the code (relating to insurance companies).

(*a*) *Certain mutualization distributions made in 1962.*—Subsection (a) of section 229 of the bill relates to stock life insurance companies which adopted a plan of mutualization before January 1, 1958.

Allowance of deduction

Paragraph (1) of section 229(a) of the bill amends section 809(d)(11) of the code (relating to certain mutualization distributions) to allow as a deduction in the computation of gain from operations, distributions made in 1962 to shareholders, in acquisition of stock, pursuant to a plan of mutualizaton adopted by the company before January 1, 1958.

Thus, your committee's amendment allows life insurance companies which adopted a plan of mutualization before January 1, 1958, an additional year (1962) to complete their plan of mutualization by acquiring their stock out of annual earnings, and to receive a deduction for amounts paid for that purpose. The amount deductible is limited to amounts actually paid to shareholders in 1962, and does not include accruals paid in subsequent years. In addition, the deduction allowed by the revised section 809(d)(11) is subject to the limitations of section 809(g) of the code (relating to limitations on deductions for certain mutualization distributions).

Application of section 815

Paragraph (2) of section 229(a) of the bill amends section 809(g)(3) of the code (relating to application of sec. 815) to extend the special rules of section 815(e) to include mutualization distributions deductible under the revised section 809(d)(11).

(*b*) *Accrual of bond discount.*—Subsection (b) of section 229 of the bill relates to the accrual of bond discount by insurance companies subject to tax under parts I and II of subchapter L of chapter 1 of the code (relating to life insurance companies, and mutual insurace companies (other than life, marine, and certain fire or flood insurance companies) etc., respectively).

Life insurance companies

Paragraph (1) of section 229(b) of the bill amends section 818(b) of the code (relating to amortization of premium and accrual of discount) by adding a new paragraph (3) at the end thereof. The new section 818(b)(3) provides that for taxable years beginning after December 31, 1962, no accrual of discount shall be required under section 818(b)(1) on any bond (as defined in section 171(d)) except as otherwise provided under subparagraphs (A) and (B) of section 818(b)(3).

Subparagraph (A) of the new section 818(b)(3) relates solely to discount on tax-exempt obligations and provides that discount which is interest described in section 103 (relating to interest on certain governmental obligations) must still be accrued. Thus, your committee's amendment makes no change in existing law with respect to issue discount (the difference between issue price and the stated redemption price at maturity) on tax-exempt obligations. Such discount must still be accrued under section 818(b)(1) of the code. On the other hand, your committee's amendment changes existing law with respect to discount on tax-exempt obligations which is not "issue discount." The accrual of such discount will no longer be required.

Subparagraph (B) of the new section 818(b)(3) relates solely to bonds which are not tax-exempt obligations within the meaning of section 103, and provides that orginal issue discount (as defined in sec. 1232(b)) must be accrued under section 818(b)(1).

Under existing law, section 818(b)(1) requires life insurance companies to accrue all discount, regardless of whether it is "issue discount," original issue discount, or "market discount." The new paragraph (3) of section 818(b) of the code changes existing law only with respect to "market discount." Such discount is no longer required to be accrued. Thus, the recognition of gain attributable to market discount is postponed until the disposition of the bond. Upon the disposition of the bond, gain attributable to market discount will ordinarily be taxable as capital gain. The adjustment to basis for the accrual of market discount will no longer be allowed to the extent such discount is not accrued by reason of the new section 818(b)(3).

The new section 818(b)(3) also provides that for purposes of section 805(b)(3)(A), the current earnings rate for any taxable year beginning before January 1, 1963, shall be determined as if the first sentence of the new section 818(b)(3) applied to such taxable year.

Mutual insurance companies

Paragraph (2) of section 229(b) of the bill amends section 822(d)(2) of the code (relating to amortization of premium and accrual of discount) by adding a new sentence at the end thereof. This sentence provides that for taxable years beginning after December 31, 1962, no accrual of discount shall be required under section 822(d)(2) of the code on any bond (as defined in sec. 171(d)). Under the new sentence neither "issue discount," original issue discount, nor "market discount," is required to be accrued under section 822(d)(2). This provision has the effect of postponing until disposition of the bond any recognition of income attributable to bond discount, at which time the provisions of section 1232 may be applicable. No adjustment in the basis of any bond attributable to discount shall be permitted for taxable years beginning after December 31, 1962, to the extent such discount is not accrued by reason of the amended section 822(d)(2).

For taxable years beginning after December 31, 1962, no discount shall be required to be accrued pursuant to section 282(d)(2) regardless of when the bond to which the discount is attributable was acquired.

(*c*) *Contributions to qualified, etc., plans.*—Subsection (c) of section 229 of the bill amends section 832(c)(10) of the code (relating to deductions allowed in computing taxable income of insurance com-

panies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies) by adding a new phrase at the end thereof. The new phrase provides that, in computing the taxable income of insurance companies subject to the tax imposed by section 831, there shall be allowed the deduction provided in part I of subchapter D of chapter 1 of the code (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.). In allowing these companies to deduct their contributions to an employees' trust or annuity plan and compensation under a deferred-payment plan under section 404 of the code, subsection (c) of section 229 of the bill is in accord with existing administrative practice.

(*d*) *Effective dates.*—Subsection (d) of section 229 of the bill provides that the amendment made by subsection (a) of the bill (relating to certain mutualization distributions made in 1962) shall apply to taxable years beginning after December 31, 1961, and that the amendment made by subsection (c) of the bill (relating to contributions to qualified, etc., plans) shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954. No provision of this section extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 230. REGULATED INVESTMENT COMPANIES

Section 230 of the bill, which is a new section added to the bill as passed by the House, relates to regulated investment companies.

(*a*) *Time for mailing certain notices to shareholders.*—Subsection (a) of section 230 of the bill amends several provisions of part I, subchapter M, chapter 1 of the code (relating to regulated investment companies) by increasing from 30 days to 45 days after the close of a taxable year the time within which a regulated investment company must give certain notices to its shareholders.

Under section 852(b)(3)(C) of existing law, a capital gain dividend is defined, in general, as any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. Under the bill, a 45-day period is substituted for the 30-day period.

Under section 852(b)(3)(D)(i) of existing law, a shareholder of a regulated investment company, in computing his long-term capital gains for his taxable year in which the last day of the regulated investment company's taxable year falls, must include such amount as the company designates as his share of undistributed capital gains in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after the close of the regulated investment company's taxable year. Under the bill, the 30-day period is changed to a 45-day period.

Section 853 of existing law provides that, if certain conditions are met, a regulated investment company may elect to treat as having been distributed to its shareholders any income, war profits, and excess profits taxes paid by it to any foreign country or to any possession of the United States. The shareholders of the company must include the amount of such taxes in gross income and must treat such amount as paid by them for purposes of the deduction under section

164(a) and the foreign tax credit under section 901. Under section 853(c), the amounts to be so treated by the shareholders may not exceed the amounts so designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. The bill changes the 30-day period to a 45-day period.

Section 854(b)(1) of existing law provides limitations to be applied in determining the extent to which any dividend (other than a capital gain dividend) may be taken into account by a shareholder of a regulated investment company for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243. Section 854(b)(2) provides that the amount of any distribution which may be taken into account as a dividend for such purposes may not exceed the amount so designated by the regulated investment company in a written notice to its shareholders mailed not later than 30 days after the close of its taxable year. The bill changes the 30-day period to a 45-day period.

Section 855 provides that, if certain conditions are met, a dividend which is paid by a regulated investment company, after the close of a taxable year, may be considered by the company as having been paid during such taxable year. Section 855(c) provides that any notice to shareholders required under part I of subchapter M with respect to such a dividend must be mailed not later than 30 days after the close of the taxable year in which the distribution of such dividend is made. The bill changes the 30-day period to a 45-day period.

(*b*) *Certain redemptions by unit investment trusts.*—Subsection (b) of section 230 of the bill amends section 852 of the code (relating to taxation of regulated investment companies and their shareholders) by adding a new subsection (d) at the end thereof.

Under section 852(b) of existing law, a regulated investment company is allowed a deduction for dividends paid (as defined in sec. 561), other than capital gains dividends, in determining its investment company taxable income, and is allowed a deduction for dividends paid (as defined in sec. 561), determined with reference to capital gains dividends only, in computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled to such preference.

New subsection (d) of section 852 provides that in the case of a unit investment trust—

(1) which is registered under the Investment Company Act of 1940 and issues periodic payment plan certificates (as defined in such act), and

(2) substantially all of the assets of which consist of securities issued by a management company (as defined in such act)—

section 562(c) shall not apply to a distribution by such trust to a holder of an interest in such trust in redemption of part or all of such interest, with respect to the net capital gain of the trust attributable to such redemption. Thus, assume that a holder of an interest in

such a trust requests that part or all of such interest be redeemed. In order to obtain the amount of cash required to redeem such interest, the trust liquidates part of its portfolio, represented by shares in a management company, and realizes a long-term capital gain on such liquidation. That amount of the cash distributed to the redeeming interest holder which represents a distribution of such realized long-term capital gain is considered to be a distribution by the trust which qualifies for the deduction for dividends paid with reference to capital gains dividends under section 852(b)(3)(A).

(*c*) *Effective dates.*—Subsection (c) of section 230 of the bill provides that the amendments made by subsection (a) shall apply to taxable years of regulated investment companies ending on or after the date of the enactment of the bill, and that the amendment made by subsection (b) shall apply to taxable years of regulated investment companies ending after December 31, 1963.

SECTION 231. FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN FOREIGN MINERAL INCOME

Section 231 of the bill, which is a new section added to the bill as passed by the House, amends section 901 (relating to credit for foreign taxes) by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) a new subsection (d) relating to foreign taxes on mineral income.

(*a*) *Foreign taxes on mineral income.*—Paragraph (1) of new subsection (d) provides that in certain cases the amount of foreign taxes described in section 901(b) (relating to amount of foreign tax allowed as a credit) which are paid or accrued during the taxable year with respect to mineral income to any foreign country (if the per-country limitation applies), or to all foreign countries (if the overall limitation applies), is to be reduced for purposes of computing the foreign tax credit. The reduction, if any, is equal to the amount by which the U.S. tax computed under chapter 1 of the code with respect to the same mineral income and computed before the allowance of any tax credit (such tax hereinafter referred to as the "U.S. tax") is exceeded by the lesser of the following two amounts: (1) The amount of such foreign taxes paid or accrued with respect to such income, or (2) the U.S. tax with respect to such income computed without the deduction for percentage depletion under section 613 but with the deduction for cost depletion determined with reference to the basis for cost depletion under section 612. The computation described in item (2) is made only to determine the amount of foreign taxes to be taken into account in computing the foreign tax credit and does not affect the manner in which a taxpayer actually computes the allowance for depletion under chapter 1 in determining the U.S. tax. In no case will the foreign tax on mineral income under new subsection (d) be reduced to an amount which is less than the U.S. tax on such mineral income. The credit for taxes paid or accrued to possessions of the United States is not affected by this provision.

Paragraph (2) of the new subsection (d) defines the term "mineral income" for purposes of subsection (d). The term means income derived from sources without the United States from mineral activities including dividends received from corporations in which 5 percent or more of the voting stock is owned directly or indirectly by the tax-

payer, to the extent such dividends are attributable to mineral activities, and that portion of the taxpayer's distributive share of partnership income attributable to mineral activities. For such purpose the term "mineral activities" includes the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. For example, in the case of oil, mineral activities of a taxpayer would include the extraction of the crude oil from the ground, transportation of the crude oil by pipeline or ship to a refinery, refining of the crude oil to obtain gasoline and other products resulting from such refining, and the sale of such products. However, the manufacture of chemical products from oil would not be considered the processing of oil into its primary products, and thus would not be considered a mineral activity. Similarly, the transportation, distribution, or sale of the chemical products would not be considered a mineral activity. If primary products of oil, such as gasoline, are sold through outlets of the taxpayer which also sell other products, only the sale of the primary products would be a mineral activity.

(*b*) *Effective date.*—The amendments made by section 231 of the bill are applicable to taxable years beginning after December 31, 1963.

SECTION 232. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

(*a*) *Treatment of certain amounts received from employer on sale of residence of employee in connection with transfer to new place of work.*—Subsection (a)(1) of section 232 of the bill, which is a new section added to the bill as passed by the House, adds a new section 1003 to part I of subchapter O of chapter 1 of the code (relating to determination of amount of and recognition of gain or loss).

It has been held that an amount received by an employee from his employer, in respect of the sale of the employee's residence in connection with his transfer to a new place of work, is taxable as compensation. (*Harris W. Bradley*, 39 T.C. 652 (1963), aff'd 324 F. 2d 610 (4th Cir. 1963); *Arthur J. Kobacker*, 37 T.C. 882 (1962).)

SECTION 1003. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

(a) *General rule.*—Subsection (a) of new section 1003 provides the general rule that if, in connection with the transfer of the taxpayer as as an employee to a new place of work, the taxpayer or his spouse sells property used as his principal residence "old residence" pursuant to a sales contract entered into within the forced sale period, and within 1 year after the date of such contract his employer pays part or all of the "sale differential," then the amount so paid shall be treated by the taxpayer or his spouse as an additional amount realized on the sale of the old residence to the extent that it does not exceed the lesser of (A) the "sale differential," or (B) 15 percent of the gross sales price of the old residence.

Section 1003 is applicable only with respect to the sale of a taxpayer's principal residence. Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each individual case. Property which qualifies as a principal residence for purposes of section 1034 will be considered a principal residence for purposes of section 1003.

Where property is used by the taxpayer partially as his principal residence and partially for business purposes or in the production of income (as in the case where a part of the building in which the taxpayer resides is used as an office or is rented), then only that portion of the reimbursement, appraised value, gross sales price, and selling expenses attributable to that part of the property used as the taxpayer's principal residence shall be considered for purposes of section 1003.

The gross sales price of the old residence is the total consideration received upon the sale by the taxpayer, and includes the amount of any mortgage, trust deed, or other indebtedness to which the property is subject in the hands of the purchaser whether or not the purchaser assumes such indebtedness. It also includes the face amount of any liabilities of the purchaser which are part of the consideration for the sale. Commissions, and other selling or fixing up expenses paid or incurred by the taxpayer in connection with the sale of the old residence, are not to be deducted or taken into account in determining the gross sales price of the old residence.

(b) *Limitations.*—Subsection (b) of new section 1003 provides certain limitations on the applicability of section 1003.

Period of employment

Paragraph (1) of subsection (b) limits the application of section 1003 to those cases where the taxpayer was employed for the 6-month period ending on the day on which he commences work at the new principal place of work by the employer who makes the reimbursement.

Location of new place of work

Paragraph (2) of subsection (b) provides that section 1003 shall not apply unless the distance between the taxpayer's new principal place of work and his old residence exceeds by at least 20 miles the distance between the taxpayer's former principal place of work and his old residence. If the taxpayer, prior to his transfer, had no principal place of work, section 1003 shall not apply unless the distance between his new principal place of work and his old residence is at least 20 miles. For purposes of measuring distances under section 1003(b)(2), all computations are to be made on the basis of a straight-line measurement.

(c) *Definitions; special rules.*—Subsection (c) of new section 1003 provides definitions and special rules for the application of section 1003.

Forced sale period

The term "forced sale period," as defined in paragraph (1) of subsection (c), is the period which begins 90 days before, and ends 180 days after, the date on which the taxpayer commences work as an employee at the new principal place of work. The term has reference

only to a period of time, and not to the nature of, or reason for, the sale.

Sale differential

The term "sale differential" is defined in paragraph (2) of subsection (c) as the amount by which (A) the appraised value of the old residence exceeds (B) the gross sales price of the old residence reduced by the selling commissions, legal fees, and other expenses incident to the transfer of ownership of the old residence. Expenses incident to the transfer of ownership refer to direct transfer costs borne by the employee. For example, such expenses do not include fixing-up expenses or traveling expenses of the employee or members of his family from or to the location of the old residence for purposes of its sale. In order for section 1003 to apply, the payment must be made by the employer to the employee as a sale differential. Thus, if an employer pays an employee a lump sum for miscellaneous costs relating to a transfer to a new place of work, only so much of such sum as is related to the sale of the old residence qualifies for treatment under section 1003.

Appraised value

The term "appraised value of the old residence", as defined in paragraph (3) of subsection (c), is the average of two or more appraisals of fair market value made, on or after the valuation date and on or before the date on which the sales contract is entered into, by independent real estate appraisers selected by the employer. Such paragraph (3) provides that the appraised value shall not exceed the fair market value of the old residence. The appraisals shall be made as of the valuation date.

Valuation date

The term "valuation date" is defined in paragraph (4) of subsection (c) as the date selected by the employer for purposes of determining the amount to be paid with respect to the sale differential. The date selected by the employer shall be a date which occurs (1) on or before the date the sales contract is entered into and (2) within the forced sale period.

Employer

The term "employer," as defined in paragraph (5) of subsection (c), means the person who employs the taxpayer as an employee at the new principal place of work. The term also includes any predecessor or successor corporation and any parent or subsidiary corporation. The determination of whether a corporation is a parent corporation or a subsidiary corporation shall be made under subsections (e) and (f) of section 425 of the code (added by sec. 222(a) of the bill) but by reference to the date on which the taxpayer commences work as an employee at the new principal place of work rather than as of the time of the granting of the option to which such section 425 relates. Thus, where a 50-percent voting stock relationship exists between the corporation for which the employee worked prior to his transfer and the corporation for which he works after his transfer, he is considered as having been employed by the same employer.

Exchanges

Paragraph (6) of subsection (c) provides that an exchange by the taxpayer or his spouse of an old residence for other property shall be treated as a sale.

Tenant-stockholder in a cooperative housing corporation

Paragraph (7) of subsection (c) provides that "property used by the taxpayer as his principal residence" includes stock held by a tenant-stockholder in a cooperative housing corporation, as those terms are defined in section 216 of the code, but only if the house or apartment which the taxpayer was entitled to occupy by reason of such stockownership was used by the taxpayer as his principal residence.

(d) *Regulations.*—Subsection (d) of new section 1003 provides that the Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of section 1003.

SECTION 232. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK—Con.

Subsection (a)(2) of section 232 of the bill amends the table of sections of part I of subchapter O of chapter 1 of the code to reflect the addition of section 1003 added by the bill.

(b) *Effective date.*—Subsection (b) of section 232 of the bill provides that the amendments made by subsection (a) shall apply to amounts paid with respect to sales contracts entered into after December 31, 1963, in taxable years ending after such date.

SECTION 233. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

Section 233 of the bill (sec. 220 of the bill as passed by the House) was approved by your committee without change. For the technical explanation of this section of the bill, see page 396 of the report of the Committee on Ways and Means on the bill.

SECTION 234. AVERAGING

Section 234 of the bill (sec. 221 of the bill as passed by the House) has been approved by your committee with three exceptions. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page 416 of the report of the Committee on Ways and Means on the bill.

First, your committee has made technical changes in the definition of the term "capital gain net income" and in the provisions relating to the computation of the alternative tax to reflect the elimination of section 219 (relating to capital gains and losses) of the bill as passed by the House.

Second, your committee has added a provision to the bill as passed by the House to allow an individual whose adjusted gross income for the computation year is under $5,000 and who chooses the benefits of income averaging to elect the standard deduction under section 144 of the code.

Third, your committee has added a provision to the bill as passed by the House restricting, in certain cases, the application of section 170(b)(5) of the code as added by section 209(c) of the bill (relating to 5-year carryover of certain excess charitable contributions by individuals).

Capital gain net income

Paragraph (1) of section 1302(d) of the code, as amended by your committee, provides that the term "capital gain net income" means the amount which is equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss. An individual's capital gain net income for any taxable year cannot be less than zero.

Computation of alternative tax

Paragraph (2) of section 1304(e) deals with the method by which an individual computes his alternative tax under section 1201 of the code for any computation year. Paragraph (2), as amended by your committee, provides that if an individual has capital gain net income for the computation year, then section 1201(b) of the code is treated as imposing a tax on the individual's income which is equal to the tax imposed by section 1 of the code, reduced by the amount (if any) by which the amount of the tax imposed by section 1 of the code which is attributable to an individual's capital gain net income for such year (as determined under paragraph (1) of section 1304(e)) exceeds the amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Amendment of section 144.—Subsection (c) of section 234 of the bill, as approved by your committee, amends section 144 of the code (relating to election of standard deduction) by adding after section 144(c) (as added by sec. 112(c)(2) of the bill) a new subsection (d).

Individuals electing income averaging

Subsection (d) of section 144 provides that if a taxpayer chooses to have the benefits of part I of subchapter Q (relating to income averaging) for a taxable year, section 144(a) of the code (relating to method and effect of election of standard deduction) shall not apply for such taxable year and the standard deduction under section 141 of the code shall be allowed if the taxpayer so elects in his return for such taxable year. The Secretary of the Treasury or his delegate shall prescribe by regulations the manner of signifying such election in the return. If the taxpayer on making his return fails to signify, in the manner prescribed by regulations, his election to take the standard deduction, such failure shall be considered his election not to take the standard deduction.

Effective date.—Subsection (g)(2) of section 234 of the bill, as approved by your committee, provides, in effect, that, in a taxable year beginning after December 31, 1963, if a taxpayer elects to apply both sections 1301 and 1307(e) of the code, as such sections were in effect immediately before the enactment of the bill, then section 170(b)(5) of the code as added by section 209(c) of the bill shall not apply to charitable contributions paid in such taxable year.

SECTION 235. SMALL BUSINESS CORPORATIONS

Section 235 of the bill, which is a new section added to the bill as passed by the House, relates to small business corporations.

(*a*) *Ownership of certain stock disregarded.*—Subsection (a) of section 235 of the bill amends section 1371 of the code (relating to the definition of a small business corporation) by adding a new subsection (d) to permit a corporation to be a small business corporation while owning the stock of certain inactive subsidiary corporations.

Under section 1371(a) of existing law, a small business corporation is not permitted to be a member of an affiliated group. New subsection (d) provides that, for purposes of section 1371(a), a corporation shall not be considered to be a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation meets the requirements provided in new paragraphs (1) and (2) of section 1371(d).

Paragraph (1) provides that the subsidiary corporation must not have begun business at any time on or after the date of its incorporation and before the close of the parent corporation's taxable year with respect to which status as a small business corporation is being sought. An example of a corporation which "has not begun business" is a corporation which is incorporated for the sole purpose of reserving a corporate name in a State or States in which the parent corporation is not doing business.

Paragraph (2) of section 1371(d) provides, in effect, that the subsidiary corporation must not have taxable income for the portions of any of its taxable years which are included within the taxable year of the parent corporation with respect to which status as a small business corporation is being sought.

Thus, for example, assume that corporation P wishes to elect to be treated under the provisions of sections 1371 through 1377 of the code for its calendar year 1964 and subsequent years. Corporation P owns all of the stock of corporation S, which is on a June 30 taxable year. Corporation P would not be precluded from making an election under section 1372 if corporation S had not begun business before January 1, 1965, and had no taxable income for either the period January 1, 1964, through June 30, 1964, or the period July 1, 1964, through December 31, 1964. Assuming that corporation P so elected with respect to its calendar year 1964, it would cease to be a small business corporation for any subsequent taxable year if corporation S either begins business before the close of such subsequent year, or has taxable income for any period included within such subsequent year.

The enactment of section 1371(d) does not relax or otherwise change the requirements of any of the provisions of subchapter S other than with respect to the requirement that a small business corporation may not be a member of an affiliated group. Thus, in the above example, the election made by corporation P under section 1372 must have been made either during the month of December 1963 or January 1964.

(*b*) *Certain distributions of money after close of taxable year.*—Subsection (b) of section 235 of the bill amends section 1375 of the code (relating to special rules applicable to distributions of electing small business corporations) by adding a new subsection (e).

Paragraph (1) of new section 1375(e) provides that, for purposes of chapter 1 of the code, a corporation which sold capital assets or property described in section 1231(b) of the code during a taxable year with respect to which it was an electing small business corporation may elect to treat as a distribution of money made on the last day of such taxable year, a distribution of money representing all or part of the proceeds of such sales of assets or property which such corporation makes to its shareholders on or before the 15th day of the third month following the close of such year, if such distribution is made pursuant to a resolution of its board of directors adopted before the close of such taxable year. Thus, if a corporation makes such an election, such distribution will be treated as actually distributed and received on the last day of such taxable year and will be taken into account in computing undistributed taxable income (as defined in sec. 1373(c)) for such taxable year to the extent that such distribution is a distribution out of earnings and profits of such taxable year as specified in section 316(a)(2).

Paragraph (2) of new section 1375(e) provides, in effect, that in order for a corporation to make an election under paragraph (1) of new section 1375(e) with respect to any distribution, each person who is a shareholder on the day the distribution is received must own as of the close of such day the same proportion of stock of such corporation as he owned as of the close of the last day of the taxable year of such corporation preceding the taxable year of the distribution, and each such shareholder must consent to such election at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations.

Paragraph (3) of new section 1375(e) provides that the election under paragraph (1) of new section 1375(e) shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election shall be made not later than the time prescribed by law for filing the return for the taxable year during which the sale was made (including extensions thereof), except that, with respect to any taxable year ending on or before the date of enactment of the bill, such election shall be made within 120 days after such date.

(*c*) *Effective dates.*—Subsection (c) of section 235 of the bill provides that the amendment made by subsection (a) of such section shall apply with respect to taxable years of corporations beginning after December 31, 1962, and that the amendment made by subsection (b) of such section shall apply with respect to taxable years of corporations beginning after December 31, 1957. No provision of this section of the bill extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 236. REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS

Section 236 of the bill (sec. 222 of the bill as passed by the House) was approved by your committee without change. For the technical explanation of this section of the bill, see page 434 of the report of the Committee on Ways and Means on the bill.

SECTION 237. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS, ETC.

Section 237 of the bill (sec. 223 of the bill as passed by the House) was approved by your committee with minor technical changes. For the technical explanation of this section (except for the amendments made by your committee), see page 435 of the report of the Committee on Ways and Means on the bill.

(*a*) *In general.*—Subsection (a) of section 237 adds a new part II (relating to certain controlled corporations) to subchapter B of chapter 6 of the code.

SECTION 1562. PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS

Additional tax imposed

The bill as passed by the House provides certain exceptions to the general rule that a corporation which is a component member of a controlled group of corporations which has made an election under new section 1562(a) of the code is subject to the additional tax imposed by section 1562(b):

1. New section 1562(b)(1) provided that the additional tax is not to apply to the taxable year of the corporation if such corporation is the only member of the controlled group which has taxable income for the taxable year.
2. Subsection (c) of section 1551 of the code (relating to disallowance of surtax exemption and accumulated earnings credit), as amended by the bill as passed by the House, provided that if the surtax exemption is disallowed to a transferee corporation under section 1551(a) for any taxable year the additional tax is not to apply with respect to such transferee for such taxable year.
3. The bill as passed by the House added a new subsection (d) to section 269 of the code (relating to acquisitions made to evade or avoid income tax) to provide that if the surtax exemption is disallowed under section 269(a) to an acquired corporation for any taxable year the additional tax is not to apply with respect to such acquired corporation for such taxable year.

Your committee has stricken out the provisions referred to in paragraphs (2) and (3), and has added to the provision referred to in paragraph (1) a general rule that the additional tax is not to apply to the taxable year of a corporation if its surtax exemption is disallowed under any provision of subtitle A of the code for such taxable year.

Tolling of statute of limitations

Your committee has made a change in subsection (g) of new section 1562 in order to make it clear that neither the Secretary of the Treasury nor his delegate nor the taxpayer may invoke such subsection for the purpose of overturning closing or compromise agreements. Thus, paragraph (2) of new section 1562(g) relating to the tolling of the statute of limitations for allowing or making claim for credit or refund of any overpayment of tax has been changed by your committee to conform to the provisions of paragraph (1) of such section, relating to the tolling of the statute of limitations for assessment of deficiencies.

SECTION 1563. DEFINITIONS AND SPECIAL RULES

Special rules

Your committee has adopted a new special rule by adding a new subparagraph (C) to new section 1563(f)(3). By reason of this addition, your committee has deleted as unnecessary a provision contained in the first parenthetical expression of section 1563(c)(2)(A)(ii). The new subparagraph (C) of section 1563(f)(3) provides that if stock is owned by a person within the meaning of section 1563(d) and such ownership results in the corporation being a component member of a controlled group, such stock shall not be treated as excluded stock under section 1563(c)(2) if by reason of treating such stock as excluded stock the result is that such corporation is not a component member of a controlled group. Thus, for example, assume corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. Also assume that O, an officer of corporation P, owns directly 30 shares of such stock and corporation P owns an option to acquire such 30 shares from O. The remaining shares of corporation S (20) are owned by unrelated persons. In the absence of the new special rule adopted by your committee, one possible construction of the applicable provisions of the House bill is that the 30 shares of stock of corporation S owned by O would be treated as excluded stock under section 1563(c)(2)(A)(ii), and corporation P would be treated as owning only 71 percent (50 divided by 70) of the stock of corporation S. Thus, corporation S would not be a component member of a controlled group of corporations within the meaning of section 1563(b). The special rule added by your committee insures, however, that the stock ownership rules contained in section 1563(d) take precedence over the excluded stock rules contained in section 1563(c)(2) when the result is to include a corporation as a component member of a controlled group of corporations which, in the absence of the new special rule, would not be the case. Thus, in the preceding example, O's stock would not be treated as excluded stock with the result that P is treated as owning 80 percent of the stock of corporation S (50 percent directly, and 30 percent constructively under sec. 1563(e)(1)) and corporation S would be a component member of a controlled group of corporations consisting of corporations P and S.

Your committee has also made minor conforming and clarifying changes in new section 1563.

(*b*) *Disallowance of surtax exemption and accumulated earnings credit.*—Subsection (b) of the bill contains amendments to section 1551 of existing law. Subsection (b)(2) of section 1551 as amended by the bill, defines the term "control" in the case of a transferee corporation described in subsection (a)(3) of such section. Subparagraph (B) of section 1551(b)(2) provides, in part, that with respect to voting stock, five or fewer individuals must own stock possessing *more than* 50 percent of the total combined voting power of all classes of stock entitled to vote. However, a slightly different test is provided with respect to the ownership requirements relating to the value of the outstanding stock. The test is that the five or fewer individuals must own stock possessing *at least* 50 percent of the total value of shares of all classes of stock. Your committee has made the voting stock and the value stock tests identical by requiring that in each case the individuals must own more than 50 percent of the particular stock in question.

(*c*) *Technical amendments.*—Subsection (c) of the bill as reported is the same as subsection (c) of the bill as passed by the House except for a conforming change.

(*d*) *Effective date.*—Subsection (d) of the bill as reported is the same as subsection (d) of the bill as passed by the House.

SECTION 238. VALIDITY OF TAX LIENS AGAINST MORTGAGEES, PLEDGEES, AND PURCHASERS OF MOTOR VEHICLES

Section 238 of the bill, which is a new section added to the bill as passed by the House, relates to the validity of tax liens on certain motor vehicles.

(*a*) *Mortgagees, pledgees, and purchasers without actual notice or knowledge of lein.*—Subsection (a) of section 238 of the bill amends section 6323(c) of the code (relating to exception in case of securities) to grant, in the case of the mortgage, pledge, or purchase of a motor vehicle, the same treatment which is now available in the case of the mortgage, pledge, or purchase of a security after notice of a tax lien has been filed. Thus, even though notice of a tax lien imposed by section 6321 has been filed, such lien will not be valid with respect to any mortgagee, pledgee, or purchaser of a motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser was without notice or knowledge of the existence of such lien.

Paragraph (1) of section 238(a) of the bill amends the heading of section 6323(c) of the code to reflect the extension of the exception contained in such subsection to cover motor vehicles.

Paragraphs (2) and (3) of section 238(a) of the bill amend paragraph (1) of section 6323(c) of the code to extend the exception contained in paragraph (1) to any mortgagee, pledgee, or purchaser of a motor vehicle without notice or knowledge of the existence of a tax lien.

Paragraph (4) of section 238(a) of the bill adds a new paragraph (3) to section 6323(c) of the code. Paragraph (3) defines the term "motor vehicle", as used in section 6323(c), as a vehicle (other than a house trailer) which is registered for highway use under the laws of any State or foreign country.

(b) *Liens for estate and gift taxes.*—Subsection (b) of section 238 of the bill amends section 6324 of the code (relating to special liens for estate and gift taxes) to grant, in the case of the mortgage, pledge, or purchase of a motor vehicle, the same treatment which is now available in the case of the mortgage, pledge, or purchase of a security after a lien for estate or gift tax has arisen. Thus, even though a special lien for estate or gift tax has arisen, such lien will not be valid with respect to any mortgagee, pledgee, or purchaser of a motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser was without notice or knowledge of the existence of such lien.

Paragraph (1) of section 238(b) of the bill amends section 6324(a) of the code (relating to liens for estate tax) and section 6324(b) of the code (relating to lien for gift tax) to extend the exception for securities now contained in those subsections to motor vehicles.

Paragraph (2) of section 238(b) of the bill amends section 6324(c) of the code (relating to exception in case of securities) by revising such subsection to cover both securities and motor vehicles.

(c) *Effective date.*—Subsection (c) of section 238 of the bill provides that the amendments made by this section apply only with respect to mortgages, pledges, and purchases made after the date of the enactment of the bill.

TITLE III—OPTIONAL TAX ON INDIVIDUALS; COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SECTION 301. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000

This section has been approved by your committee without change. For the technical explanation of this section of the bill see page 462 of the report of the Committee on Ways and Means on the bill.

SECTION 302. INCOME TAX COLLECTED AT SOURCE

Section 302 of the bill amends section 3402 of the code (relating to income tax collected at source) and section 1441 of the code (relating to withholding of tax on nonresident aliens).

(*a*) *Percentage method of withholding.*—Subsection (a) of section 302 of the bill amends section 3402(a) of the code (relating to income tax collected at source). Under the bill as passed by the House, section 3402(a) of the code provided for a 15-percent withholding rate in the case of wages paid during the calendar year 1964 and a 14-percent withholding rate in the case of wages paid after December 31, 1964. Your committee has amended section 3042(a) to provide for a 14-percent withholding rate in the case of wages paid after the seventh day following the date of the enactment of the bill.

(*b*) *Wage bracket withholding.*—Subsection (b) of section 302 of the bill amends section 3402(c)(1) of the code (relating to wage bracket withholding). Under the bill as passed by the House, section 3402(c)(1) of the code provided new withholding tables for wages paid during the calendar year 1964, and new tables for wages paid after December 31, 1964. Your committee has amended section 3402(c)(1) to provide that the new withholding tables which would have become effective for wages paid after December 31, 1964, under the bill as passed by the House will become effective for wages paid after the seventh day following the date of the enactment of the bill.

(*c*) *Withholding of tax on certain nonresident aliens.*—Subsection (c) of section 302 of the bill amends sections 1441 (a) and (b) of the code (relating to withholding of tax on nonresident aliens). Under the bill as passed by the House, section 1441(a) of the code provided a 15–percent withholding rate in the case of certain payments made during the calendar year 1964 and a 14-percent withholding rate in the case of certain payments made after December 31, 1964. Your committee has amended section 1441(a) to provide a 14-percent withhold-

ing rate in the case of these payments made after the seventh day following the date of the enactment of the bill.

Under the bill as passed by the House, section 1441(b) of the code referred to the rates of 15 percent or 14 percent provided by the amended section 1441(a). Your committee has amended section 1441(b) to refer to the new 14-percent rate which is provided by amended section 1441(a).

(*d*) *Effective dates.*—Subsection (d) of section 302 of the bill as passed by the House provided that the amendments made by subsections (a) and (b) of such section apply with respect to remuneration paid after December 31, 1963, and that the amendment made by subsection (c) applies with respect to payments made after December 31, 1963. Your committee's amendment provides that the amendments made by subsections (a) and (b) of such section apply with respect to remuneration paid after the seventh day following the date of the enactment of the bill, and that the amendment made by subsection (c) of such section applies with respect to payments made after the seventh day following the date of the enactment of the bill.

[H.R. 8363][1]

REVENUE ACT OF 1964

[Conference Report No. 1149, Eighty-eighth Congress, Second Session]

[February 24, 1964]

Mr. Mills, from the committee of conference, submitted the following Conference Report to accompany H.R. 8363.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its amendments numbered 1, 2, 53, 56, 129, 132, 135, 142, 143, 144, 146, 164, 165, 195, 199, 200, 201, 202, and 203.

That the House recede from its disagreement to the amendments of the Senate numbered 3, 4, 5, 6, 7, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 21, 22, 23, 24, 25, 28, 29, 30, 33, 34, 35, 37, 38, 39, 40, 41, 44, 45, 48, 49, 51, 52, 63, 64, 65, 66, 67, 68, 69, 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82, 83, 84, 85, 86, 87, 88, 89, 90, 91, 92, 93, 94, 95, 102, 103, 107, 108, 109, 110, 111, 112, 113, 114, 115, 116, 117, 118, 119, 120, 121, 122, 123, 124, 125, 126, 127, 128, 130, 131, 133, 134, 136, 137, 138, 139, 140, 148, 150, 151, 152, 153, 154, 155, 156, 157, 158, 159, 160, 161, 169, 170, 171, 172, 173, 174, 175, 176, 180, 181, 182, 183, 184, 186, 187, 188, 189, 190, 191, 192, 204, 205, 206, 207, and 208, and agree to the same.

Amendment numbered 8:

That the House recede from its disagreement to the amendment of the Senate numbered 8, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

[1] Public Law 88–272, page 6, this Bulletin.

SEC. 202. RETIREMENT INCOME CREDIT OF CERTAIN MARRIED INDIVIDUALS.

(a) Determination of Retirement Income.—Section 37 (relating to retirement income) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) Special Rules for Certain Married Couples.—

"(1) Election.—A husband and wife who make a joint return for the taxable year and both of whom have attained the age of 65 before the close of the taxable year may elect (at such time and in such manner as the Secretary or his delegate by regulations prescribes) to determine the amount of the credit allowed by subsection (a) by applying the provisions of paragraph (2).

"(2) Special rules.—If an election is made under paragraph (1) for the taxable year, for purposes of subsection (a)—

"(A) if either spouse is an individual who has received earned income within the meaning of subsection (b), the other spouse shall be considered to be an individual who has received earned income within the meaning of such subsection; and

"(B) subsection (d) shall be considered as providing that the amount of the combined retirement income of both spouses shall not exceed $2,286, less the sum of the amounts specified in paragraphs (1) and (2) of subsection (d) for each spouse."

(b) Effective Date.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1963.

And the Senate agree to the same.

Amendment numbered 20:

That the House recede from its disagreement to the amendment of the Senate numbered 20, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following:

"(1) the cost of $50,000 of such insurance, and

And the Senate agree to the same.

Amendment numbered 26:

That the House recede from its disagreement to the amendment of the Senate numbered 26, and agree to the same with an amendment, as follows:

Page 7, in the last line of the matter following line 3, of the Senate engrossed amendments, strike out "222" and insert: *221*; and the Senate agree to the same.

Amendment numbered 27:

That the House recede from its disagreement to the amendment of the Senate numbered 27, and agree to the same with an amendment, as follows:

Page 7, line 6, of the Senate engrossed amendments, strike out "222" and insert: *221*; and the Senate agree to the same.

Amendment numbered 31:

That the House recede from its disagreement to the amendment of the Senate numbered 31, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following:

period, if such amounts are at a rate which exceeds 75 percent of the regular weekly rate of wages of the employee (as determined under regulations prescribed by the Secretary or his delegate). If amounts attributable to the first 30 calendar days in such period are at a rate which does not exceed 75 percent of the regular weekly rate of wages of the employee, the first sentence of this subsection (1) shall not apply to the extent that such amounts exceed a weekly rate of $75, and (2) shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of personal injuries or sickness for at least one day during such period."

And the Senate agree to the same.

Amendment numbered 32:

That the House recede from its disagreement to the amendment of the Senate numbered 32, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

"*(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.*

And the Senate agree to the same.

Amendment numbered 36:

That the House recede from its disagreement to the amendment of the Senate numbered 36, and agree to the same with amendments as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

(b) UNLIMITED CHARITABLE CONTRIBUTION DEDUCTION.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by inserting after subsection (f) (added by subsection (e) of this section) the following new subsection:

"(g) APPLICATION OF UNLIMITED CHARITABLE CONTRIBUTION DEDUCTION.—

"(1) ALLOWANCE OF DEDUCTION FOR TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1963.—If the taxable year begins after December 31, 1963—

"(A) subsection (b)(1)(C) shall apply only if the taxpayer so elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes); and

"(B) for purposes of subsection (b)(1)(C), the amount of the charitable contributions for the taxable year (and for all prior taxable years beginning after December 31, 1963) shall be determined without the application of subsection (b)(5) and solely by reference to charitable contributions described in paragraph (2).

If the taxpayer elects to have subsection (b)(1)(C) apply for the taxable year, then for such taxable year subsection (a) shall apply

only with respect to charitable contributions described in paragraph (2), and no amount of charitable contributions made in the taxable year or any prior taxable year may be treated under subsection (b)(5) as having been made in the taxable year or in any succeeding taxable year.

"(2) *Qualified contributions.—The charitable contributions referred to in paragraph (1) are—*

"(A) *any charitable contribution described in subsection (b)(1)(A);*

"(B) *any charitable contribution, not described in subsection (b)(1)(A), to an organization described in subsection (c)(2) substantially more than half of the assets of which is devoted directly to, and substantially all of the income of which is expended directly for, the active conduct of the activities constituting the purpose or function for which it is organized and operated;*

"(C) *any charitable contribution, not described in subsection (b)(1)(A), to an organization described in subsection (c)(2) which meets the requirements of paragraph (3) with respect to such charitable contribution; and*

"(D) *any charitable contribution payment of which is made on or before the date of the enactment of the Revenue Act of 1964.*

"(3) *Organizations expending at least 50 percent of donor's contributions.—An organization shall be an organization referred to in paragraph (2)(C), with respect to any charitable contribution, only if—*

"(A) *not later than the close of the third year after the organization's taxable year in which the contribution is received (or before such later time as the Secretary or his delegate may allow upon good cause shown by such organization), such organization expends an amount equal to at least 50 percent of such contribution for—*

"(i) *the active conduct of the activities constituting the purpose or function for which it is organized and operated,*

"(ii) *assets which are directly devoted to such active conduct,*

"(iii) *contributions to organizations which are described in subsection (b)(1)(A) or in paragraph (2)(B) of this subsection, or*

"(iv) *any combination of the foregoing; and*

"(B) *for the period beginning with the taxable year in which such contribution is received and ending with the taxable year in which subparagraph (A) is satisfied with respect to such contribution, such organization expends all of its net income (determined without regard to capital gains and losses) for the purposes described in clauses (i), (ii), (iii), and (iv) of subparagraph (A).*

If the taxpayer so elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes) with respect to contributions made by him to any organization, then, in applying subparagraph (B) with respect to contributions made by him to such organization during his taxable year for which such election is made

and during all his subsequent taxable years, amounts expended by the organization after the close of any of its taxable years and on or before the 15th day of the third month following the close of such taxable year shall be treated as expended during such taxable year.

"(4) DISQUALIFYING TRANSACTIONS.—*An organization shall be an organization referred to in subparagraph (B) or (C) of paragraph (2) only if at no time during the period consisting of the organization's taxable year in which the contribution is received, its 3 preceding taxable years, and its 3 succeeding taxable years, such organization—*

"(A) *lends any part of its income or corpus to,*

"(B) *pays compensation (other than reasonable compensation for personal services actually rendered) to,*

"(C) *makes any of its services available on a preferential basis to,*

"(D) *purchases more than a minimal amount of securities or other property from, or*

"(E) *sells more than a minimal amount of securities or other property to,*

the donor of such contribution, any member of his family (as defined in section 267(c)(4)), any employee of the donor, any officer or employee of a corporation in which he owns (directly or indirectly) 50 percent or more in value of the outstanding stock, or any partner or employee of a partnership in which he owns (directly or indirectly) 50 percent or more of the capital interest or profits interest. This paragraph shall not apply to transactions occurring on or before the date of the enactment of the Revenue Act of 1964."

Page 62, line 3, of the House engrossed bill, strike out "(g) and (h)," and insert: *(h) and (i),*

And the Senate agree to the same.

Amendment numbered 42:

That the House recede from its disagreement to the amendment of the Senate numbered 42, and agree to the same with an amendment as follows:

Page 14, line 8, of the Senate engrossed amendments, strike out the period and insert:

, except that such amendments shall not apply to any transfer of a future interest made before July 1, 1964, where—

(A) the sole intervening interest or right is a nontransferable life interest reserved by the donor, or

(B) in the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable life interest reserved by the donors which expires not later than the death of whichever of such donors dies later.

For purposes of the exception contained in the preceding sentence, a right to make a transfer of the reserved life interest to the donee of the future interest shall not be treated as making a life interest transferable.

And the Senate agree to the same.

Amendment numbered 43:

That the House recede from its disagreement to the amendment of the Senate numbered 43, and agree to the same with an amendment as follows:

Page 16, lines 1 and 2, of the Senate engrossed amendments, strike out "may be prescribed by the Secretary or his delegate" and insert: *the Secretary or his delegate by regulations prescribes*

And the Senate agree to the same.

Amendment numbered 46:

That the House recede from its disagreement to the amendment of the Senate numbered 46, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following:

> "(*B*) *The $600 limit of subparagraph* (*A*) *shall be increased* (*to an amount not above $900*) *by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had 2 or more dependents.*

And the Senate agree to the same.

Amendment numbered 47:

That the House recede from its disagreement to the amendment of the Senate numbered 47, and agree to the same with an amendment as follows:

Page 19, line 21, of the Senate engrossed amendments, strike out "$7,000" and insert: *$6,000*

And the Senate agree to the same.

Amendment numbered 50:

That the House recede from its disagreement to the amendment of the Senate numbered 50, and agree to the same with amendments as follows:

Strike out the matter proposed to be stricken out and omit the matter proposed to be inserted by the Senate amendment.

Page 68, line 8, of the House engrossed bill, strike out "219" and insert: *218*

Page 71 of the House engrossed bill, in the matter following line 14, strike out " 'Sec. 219. Cross references.' " and insert: *"Sec. 218. Cross references."*

And the Senate agree to the same.

Amendment numbered 54:

That the House recede from its disagreement to the amendment of the Senate numbered 54, and agree to the same with an amendment as follows:

Page 22, line 18, of the Senate engrossed amendments, strike out "215" and insert: *214*; and the Senate agree to the same.

Amendment numbered 55:

That the House recede from its disagreement to the amendment of the Senate numbered 55, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *215*; and the Senate agree to the same.

Amendment numbered 57:

That the House recede from its disagreement to the amendment of the Senate numbered 57, and agree to the same with amendments as follows:

Page 31, line 18, of the Senate engrossed amendments, strike out "217" and insert: *216*

Page 32, line 1, of the Senate engrossed amendments, beginning with "which" strike out all through "80a–2))" in line 5 and insert: *which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and which is subject to the banking laws of the State in which such institution is incorporated, interest on face-amount certificates (as defined in section 2(a)(15) of such Act)*

Page 32, line 13, of the Senate engrossed amendments, strike out "25 percent" and insert: *15 percent*

And the Senate agree to the same.

Amendment numbered 58:

That the House recede from its disagreement to the amendment of the Senate numbered 58, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 217. LIMITATION OF TRAVEL ALLOCATION REQUIREMENT TO FOREIGN TRAVEL.

(a) LIMITATION OF APPLICATION OF SECTION 274(c).—Section 274(c) (relating to traveling) is amended to read as follows:

"(c) CERTAIN FOREIGN TRAVEL.—

"(1) IN GENERAL.—In the case of any individual who travels outside the United States away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary or his delegate, is not allocable to such trade or business or to such activity.

"(2) EXCEPTION.—Paragraph (1) shall not apply to the expenses of any travel outside the United States away from home if—

"(A) such travel does not exceed one week, or

"(B) the portion of the time of travel outside the United States away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time on such travel.

"(3) DOMESTIC TRAVEL EXCLUDED.—For purposes of this subsection, travel outside the United States does not include any travel from one point in the United States to another point in the United States."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

And the Senate agree to the same.

Amendment numbered 59:

That the House recede from its disagreement to the amendment of the Senate numbered 59, and agree to the same with an amendment as follows:

Page 33, line 6, of the Senate engrossed amendments, strike out "219" and insert: *218*; and the Senate agree to the same.

Amendment numbered 60:

That the House recede from its disagreement to the amendment of the Senate numbered 60, and agree to the same with an amendment as follows:

Page 35, line 2, of the Senate engrossed amendments, strike out "220" and insert: *219*; and the Senate agree to the same.

Amendment numbered 61:

That the House recede from its disagreement to the amendment of the Senate numbered 61, and agree to the same with amendments as follows:

Page 37, line 2, of the Senate engrossed amendments, strike out "221" and insert: *220*

Page 44 of the Senate engrossed amendments, after line 22, insert:

If for the period (or part thereof) referred to in clauses (ii) and (iii) such corporation has no gross income, the provisions of clauses (ii) and (iii) shall be treated as satisfied if it is reasonable to anticipate that, with respect to the first taxable year thereafter for which such corporation has gross income, the provisions of such clauses will be satisfied.

And the Senate agree to the same.

Amendment numbered 62:

That the House recede from its disagreement to the amendment of the Senate numbered 62, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *221*; and the Senate agree to the same.

Amendment numbered 70:

That the House recede from its disagreement to the amendment of the Senate numbered 70, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

"*(6) APPLICATION OF SUBSECTION (b)(5) WHERE OPTIONS ARE FOR STOCK OF SAME CLASS IN SAME CORPORATION.—The requirement of subsection (b)(5) shall be considered to have been met in the case of any option (referred to in this paragraph as 'new option') granted to an individual if—*

"*(A) the new option and all outstanding options referred to in subsection (b)(5) are to purchase stock of the same class in the same corporation, and*

"*(B) the new option by its terms is not exercisable while there is outstanding (within the meaning of paragraph (2)) any qualified stock option (or restricted stock option) which was granted, before the granting of the new option, to such individual*

to purchase stock in such corporation at a price (determined as of the date of grant of the new option) higher than the option price of the new option.

And the Senate agree to the same.

Amendment numbered 96:

That the House recede from its disagreement to the amendment of the Senate numbered 96, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 222. SALES AT RETAIL UNDER REVOLVING CREDIT PLANS.

(a) TREATMENT UNDER INSTALLMENT METHOD.—Section 453 (relating to installment method of accounting) is amended by adding at the end thereof the following new subsection:

"(e) REVOLVING CREDIT TYPE PLANS.—For purposes of subsection (a), the term 'installment plan' includes a revolving credit type plan which provides that the purchaser of personal property at retail may pay for such property in a series of periodic payments of an agreed portion of the amounts due the seller under the plan, except that such term does not include any such plan with respect to a purchaser who uses his account primarily as an ordinary charge account."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply in respect of sales made during taxable years beginning after December 31, 1963.

And the Senate agree to the same.

Amendment numbered 97:

That the House recede from its disagreement to the amendment of the Senate numbered 97, and agree to the same with amendments as follows:

Page 57, line 14, of the Senate engrossed amendments, strike out "224" and insert: *223*

Page 57, line 14, of the Senate engrossed amendments, strike out **"AND CREDITS"**

Page 57, line 17, of the Senate engrossed amendments, strike out "OR CREDIT"

Page 58, line 4, of the Senate engrossed amendments, strike out "or credit"

Page 58, line 6, of the Senate engrossed amendments, strike out "or credit"

Page 58, line 7, of the Senate engrossed amendments, after the period and before the quotation marks insert: *This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.*

Page 58, line 11, of the Senate engrossed amendments, strike out "sentence" and insert: *sentences*

Page 58, line 19, of the Senate engrossed amendments, strike out "or credit"

Page 58, line 22, of the Senate engrossed amendments, strike out "or credit"

Page 58, line 23, of the Senate engrossed amendments, after the period and before the quotation marks insert: *The preceding sentence*

shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

Page 60, line 4, of the Senate engrossed amendments, strike out "or credit"

Page 61, line 3, of the Senate engrossed amendments, strike out "or credit"

Page 61, line 12, of the Senate engrossed amendments, strike out "or credit"

And the Senate agree to the same.

Amendment numbered 98:

That the House recede from its disagreement to the amendment of the Senate numbered 98, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *224*; and the Senate agree to the same.

Amendment numbered 99:

That the House recede from its disagreement to the amendment of the Senate numbered 99, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out by the Senate amendment and in lieu thereof insert the following:

(c) CERTAIN CARRYING CHARGES.—Section 163(b)(1) (relating to installment purchases where interest charge is not separately stated) is amended—

(1) by striking out "personal property is purchased" and inserting in lieu thereof "personal property or educational services are purchased"; and

(2) by adding at the end thereof the following new sentence: "For purposes of this paragraph, the term 'educational services' means any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4)) and which is provided for a student of such institution."

And the Senate agree to the same.

Amendment numbered 100:

That the House recede from its disagreement to the amendment of the Senate numbered 100, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following:

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963, other than any sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963. The amendments made by subsection (c) shall apply to payments made during taxable years beginning after December 31, 1963.

And the Senate agree to the same.

Amendment numbered 101:

That the House recede from its disagreement to the amendment of the Senate numbered 101, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *225*; and the Senate agree to the same.

Amendment numbered 104:

That the House recede from its disagreement to the amendment of the Senate numbered 104, and agree to the same with an amendment, as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *obligations,*; and the Senate agree to the same.

Amendment numbered 105:

That the House recede from its disagreement to the amendment of the Senate numbered 105, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

> "*(iii) rendering services or making facilities available in connection with activities described in clauses (i) and (ii) carried on by the corporation rendering services or making facilities available, or*
>
> "*(iv) rendering services or making facilities available to another corporation which is engaged in the lending or finance business (within the meaning of this paragraph), if such services or facilities are related to the lending or finance business (within such meaning) of such other corporation and such other corporation and the corporation rendering services or making facilities available are members of the same affiliated group (as defined in section 1504).*

And the Senate agree to the same.

Amendment numbered 106:

That the House recede from its disagreement to the amendment of the Senate numbered 106, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following:

> *unless the loans, notes, or installment obligations are evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements arising out of the sale of goods or services in the course of the borrower's or transferor's trade or business, or*

And the Senate agree to the same.

Amendment numbered 141:

That the House recede from its disagreement to the amendment of the Senate numbered 141, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out by the Senate amendment and in lieu thereof insert:

(*j*) *Increase in Basis With Respect to Certain Foreign Personal Holding Company Stock or Securities.*—

(1) *In general.—Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by redesignating section 1022 as section 1023 and by inserting after section 1021 the following new section:*

"SEC. 1022. INCREASE IN BASIS WITH RESPECT TO CERTAIN FOREIGN PERSONAL HOLDING COMPANY STOCK OR SECURITIES.

"(a) General Rule.—The basis (determined under section 1014(b)(5), relating to basis of stock or securities in a foreign personal holding company) of a share of stock or a security, acquired from a decedent dying after December 31, 1963, of a corporation which was a foreign personal holding company for its most recent taxable year ending before the date of the decedent's death shall be increased by its proportionate share of any Federal estate tax attributable to the net appreciation in value of all of such shares and securities determined as provided in this section.

"(b) Proportionate Share.—For purposes of subsection (a), the proportionate share of a share of stock or of a security is that amount which bears the same ratio to the aggregate increase determined under subsection (c)(2) as the appreciation in value of such share or security bears to the aggregate appreciation in value of all such shares and securities having appreciation in value.

"(c) Special Rules and Definitions.—For purposes of this section—

"(1) Federal estate tax.—The term 'Federal estate tax' means only the tax imposed by section 2001 or 2101, reduced by any credit allowable with respect to a tax on prior transfers by section 2013 or 2102.

"(2) Federal estate tax attributable to net appreciation in value.—The Federal estate tax attributable to the net appreciation in value of all shares of stock and securities to which subsection (a) applies is that amount which bears the same ratio to the Federal estate tax as the net appreciation in value of all of such shares and securities bears to the value of the gross estate as determined under chapter 11 (including section 2032, relating to alternate valuation).

"(3) Net appreciation.—The net appreciation in value of all shares and securities to which subsection (a) applies is the amount by which the fair market value of all such shares and securities exceeds the adjusted basis of such property in the hands of the decedent.

"(4) Fair market value.—For purposes of this section, the term 'fair market value' means fair market value determined under chapter 11 (including section 2032, relating to alternate valuation).

"(d) Limitations.—This section shall not apply to any foreign personal holding company referred to in section 342(a)(2)."

(2) Amendment of section 1016(a).—Section 1016(a) (relating to adjustments to basis) is amended by striking out the period at the end thereof and by inserting in lieu thereof a semicolon and by adding at the end thereof the following new paragraph:

"(21) to the extent provided in section 1022, relating to increase in basis for certain foreign personal holding company stock or securities."

(3) Clerical amendment.—The table of sections for part II of subchapter O of chapter 1 is amended by striking out

"Sec. 1022. Cross references."

and inserting in lieu thereof the following:

"Sec. 1022. Increase in basis with respect to certain foreign personal holding company stock or securities.
"Sec. 1023. Cross references."

And the Senate agree to the same.

Amendment numbered 145:

That the House recede from its disagreement to the amendment of the Senate numbered 145, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out by the Senate amendment and in lieu thereof insert:

(4) The amendments made by subsection (j) shall apply in respect of decedents dying after December 31, 1963.

And the Senate agree to the same.

Amendment numbered 147:

That the House recede from its disagreement to the amendment of the Senate numbered 147, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *226*; and the Senate agree to the same.

Amendment numbered 149:

That the House recede from its disagreement to the amendment of the Senate numbered 149, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *227*; and the Senate agree to the same.

Amendment numbered 162:

That the House recede from its disagreement to the amendment of the Senate numbered 162, and agree to the same with an amendment as follows:

Page 68, line 22, of the Senate engrossed amendments, strike out "229" and insert: *228*; and the Senate agree to the same.

Amendment numbered 163:

That the House recede from its disagreement to the amendment of the Senate numbered 163, and agree to the same with an amendment as follows:

Page 70, line 22, of the Senate engrossed amendments, strike out "230" and insert: *229*; and the Senate agree to the same.

Amendment numbered 166:

That the House recede from its disagreement to the amendment of the Senate numbered 166, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out by the Senate amendment and in lieu thereof insert the following:

SEC. 230. CAPITAL LOSS CARRYOVERS FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) In General.—Section 1212 (relating to capital loss carryover) is amended—

(1) by striking out "If for any taxable year the taxpayer" and inserting in lieu thereof:

"(a) Corporations.—If for any taxable year a corporation"; and

(2) by adding at the end thereof the following new subsection:

"(b) Other Taxpayers.—

"(1) In general.—If a taxpayer other than a corporation has a net capital loss for any taxable year beginning after December 31, 1963—

"(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

"(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

For purposes of this paragraph, in determining such excesses an amount equal to the excess of the sum allowed for the taxable year under section 1211(b) over the gains from sales or exchanges of capital assets (determined without regard to this sentence) shall be treated as a short-term capital gain in such year.

"(2) Transitional rule.—In the case of a taxpayer other than a corporation, there shall be treated as a short-term capital loss in the first taxable year beginning after December 31, 1963, any amount which is treated as a short-term capital loss in such year under this subchapter as in effect immediately before the enactment of the Revenue Act of 1964."

(b) Technical Amendments.—

(1) Section 1222(9) (relating to net capital gain) is amended to read as follows:

"(9) Net capital gain.—In the case of a corporation, the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges."

(2) The second sentence of section 1222(10) (relating to net capital loss) is amended by striking out "For the purpose" and inserting in lieu thereof "In the case of a corporation, for the purpose".

(c) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1963.

And the Senate agree to the same.

Amendment numbered 167:

That the House recede from its disagreement to the amendment of the Senate numbered 167, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *231*; and the Senate agree to the same.

Amendment numbered 168:

That the House recede from its disagreement to the amendment of the Senate numbered 168, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *232*; and the Senate agree to the same.

Amendment numbered 177:

That the House recede from its disagreement to the amendment of the Senate numbered 177, and agree to the same with an amendment as follows:

Page 81, line 11, of the Senate engrossed amendments, strike out "235" and insert: *233*; and the Senate agree to the same.

Amendment numbered 178:

That the House recede from its disagreement to the amendment of the Senate numbered 178, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *234*; and the Senate agree to the same.

Amendment numbered 179:

That the House recede from its disagreement to the amendment of the Senate numbered 179, and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out and in lieu of the matter proposed to be inserted by the Senate amendment insert the following: *235*; and the Senate agree to the same.

Amendment numbered 185:

That the House recede from its disagreement to the amendment of the Senate numbered 185, and agree to the same with an amendment, as follows:

Strike out the matter proposed to be stricken out and insert the matter proposed to be inserted by the Senate amendment and on page 268 of the House engrossed bill strike out lines 20, 21, and 22, and insert:

> *(C) Adopted Child—For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual by blood.*

And the Senate agree to the same.

Amendment numbered 193:

That the House recede from its disagreement to the amendment of the Senate numbered 193, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 236. VALIDITY OF TAX LIENS AGAINST PURCHASERS OF MOTOR VEHICLES.

(a) Purchasers Without Actual Notice or Knowledge of Lien.—Section 6323 (relating to validity of liens for Federal taxes) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) Exception in Case of Motor Vehicles.—

"(1) Exception.—Even though notice of a lien provided in section 6321 has been filed in the manner prescribed in subsection (a) of this section, the lien shall not be valid with respect to a motor vehicle, as defined in paragraph (2) of this subsection, as against any purchaser of such motor vehicle for an adequate and full consideration in money or money's worth if—

"(A) at the time of the purchase the purchaser is without notice or knowledge of the existence of such lien, and

"(B) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

"(2) Definition of motor vehicle.—As used in this subsection, the term 'motor vehicle' means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country."

(b) Liens for Estate and Gift Taxes.—Section 6324 (relating to special lien for estate and gift taxes) is amended by adding at the end thereof the following new subsection:

"(d) Exception in Case of Motor Vehicles.—The lien imposed by subsection (a) or (b) shall not be valid with respect to a motor vehicle, as defined in section 6323(d)(2), as against any purchaser of such motor vehicle for an adequate and full consideration in money or money's worth if—

"(1) at the time of the purchase the purchaser is without notice or knowledge of the existence of such lien, and

"(2) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent."

(c) Clerical Amendments.—

(1) Section 6323(a) is amended by striking out "subsection (c)" and inserting in lieu thereof "subsections (c) and (d)".

(2) Section 6324 is amended by inserting after "subsection (c) (relating to transfers of securities)" in subsections (a) and (b) the following: "and subsection (d) (relating to purchases of motor vehicles)".

(d) Effective Dates.—The amendments made by this section shall apply only with respect to purchases made after the date of the enactment of this Act.

And the Senate agree to the same.

Amendment numbered 194:

That the House recede from its disagreement to the amendment of the Senate numbered 194, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 237. EXCLUSION OF EARNED INCOME OF CERTAIN UNITED STATES CITIZENS WHO ARE RESIDENTS OF FOREIGN COUNTRIES.

(*a*) *Reduction of Limitation.—Subparagraph* (*B*) *of section 911*(*c*)(*1*) (*relating to limitations on amount of exclusion*) *is amended by striking out "$35,000" and inserting in lieu thereof "$25,000".*

(*b*) *Effective Date.—The amendment made by subsection* (*a*) *shall apply to taxable years beginning after December 31, 1964.*

And the Senate agree to the same.

Amendment numbered 196:

That the House recede from its disagreement to the amendment of the Senate numbered 196, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 238. LOSSES ARISING FROM CONFISCATION OF PROPERTY BY CUBA.

Section 165 (*relating to losses*) *is amended by redesignating subsection* (*i*) *as subsection* (*j*) *and by inserting after subsection* (*h*) *the following new subsection:*

"(*i*) *Certain Property Confiscated by Cuba.—For purposes of this chapter, any loss of tangible property, if such loss arises from expropriation, intervention, seizure, or similar taking by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, shall be treated as a loss from a casualty within the meaning of subsection* (*c*)(*3*)*."*

And the Senate agree to the same.

Amendment numbered 197:

That the House recede from its disagreement to the amendment of the Senate numbered 197, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. 239. CREDIT OR REFUND OF SELF-EMPLOYMENT TAX.

Section 6511 (*relating to limitations on credit or refund*) *is amended by adding at the end of subsection* (*d*) *the following new paragraph:*

> *"*(*5*) *Special period of limitation with respect to self-employment tax in certain cases.—If the claim for credit or refund relates to an overpayment of the tax imposed by chapter 2* (*relating to the tax on self-employment income*) *attributable to an agreement, or modification of an agreement, made pursuant to section 218 of the Social Security Act* (*relating to coverage of State and local employees*)*, and if the allowance of a credit or refund of such overpayment is otherwise prevented by the operation of any law or rule*

of law other than section 7122 (relating to compromises), such credit or refund may be allowed or made if claim therefor is filed on or before the later of the following dates: (A) the last day of the second year after the calendar year in which such agreement (or modification) is agreed to by the State and the Secretary of Health, Education, and Welfare, or (B) December 31, 1965."

And the Senate agree to the same.

Amendment numbered 198:

That the House recede from its disagreement to the amendment of the Senate numbered 198, and agree to the same with amendments as follows:

Page 92, line 2, of the Senate engrossed amendments, strike out "243" and insert: *240*

Page 93, line 3, of the Senate engrossed amendments, after "1939" insert: *attributable to such interest, including any extensions thereof,*

And the Senate agree to the same.

W. D. MILLS,
CECIL R. KING,
THOS. J. O'BRIEN,
HALE BOGGS,
JOHN W. BYRNES,
VICTOR A. KNOX,
Managers on the Part of the House.

HARRY F. BYRD,
RUSSELL B. LONG,
GEORGE SMATHERS,
CLINTON P. ANDERSON,
JOHN J. WILLIAMS,
FRANK CARLSON,
WALLACE F. BENNETT,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

The following Senate amendments made technical, clerical, clarifying, or conforming changes: 2, 3, 5, 6, 7, 9, 14, 15, 19, 22, 24, 27, 28, 33, 34, 38, 39, 40, 44, 45, 48, 49, 50, 51, 52, 55, 62, 63, 65, 68, 69, 72, 73, 75, 77, 78, 79, 80, 89, 90, 92, 93, 94, 98, 101, 103, 104, 110, 112, 113, 115, 118, 120, 121, 122, 123, 125, 126, 127, 128, 130, 134, 135, 136, 138, 140, 142, 143, 144, 145, 146, 147, 148, 149, 150, 152, 154, 155, 156, 157, 158, 159, 160, 161, 167, 168, 169, 170, 172, 173, 174, 175, 176, 178, 179, 180, 181, 182, 183, 184, 185, 186, 187, 188, 189, 190, 191, and 192. With respect to these amendments (1) the House either recedes or recedes with amendments which are technical, clerical, clarifying, or conforming in nature; or (2) the Senate recedes in order to conform to other action agreed upon by the committee of conference.

DECLARATION BY CONGRESS

Amendment No. 1: Section 1 of the bill as passed by the House provided that it is the sense of Congress that the tax reduction provided by the bill, through stimulation of the economy, will, after a brief transitional period, raise (rather than lower) revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. Such section also provided that, to further the objective of obtaining balanced budgets in the near future, Congress by this action recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective. Senate amendment No. 1 strikes out this section of the bill.

The Senate recedes.

REDUCTION OF TAX RATES—RETIREMENT INCOME CREDIT

Amendment No. 4: Section 37(a) of the code provides the general rule that the credit against tax for retirement income shall be determined by multiplying the retirement income (as defined in and limited by sec. 37) by the rate provided in section 1 of the code (relating to tax imposed on individuals) for the first $2,000 of taxable income. The bill as passed by the House provided that the credit shall be equal to 15 percent of such retirement income. Senate amendment

No. 4 retains the change made by the bill as passed by the House except that in the case of a taxable year beginning in 1964 the amendment provides that the credit shall be equal to 17 percent of such retirement income.

The House recedes.

RETIREMENT INCOME CREDIT IN CASE OF CERTAIN JOINT RETURNS

Amendment No. 8: Section 37 of the code provides a credit against tax for retirement income. To be eligible for the credit, an individual must have received earned income in excess of $600 in each of 10 calendar years before the taxable year and (except in the case of pensions and annuities under a public retirement system) must have attained the age of 65 before the close of the taxable year. Under section 37(d) of the code the amount of retirement income taken into account in the case of any individual may not exceed $1,524 less (1) amounts received in the taxable year as pensions and annuities (including social security and railroad retirement benefits) which are excluded from gross income, and (2) if the individual has not attained the age of 72, adjustments for earned income received in the taxable year.

Senate amendment No. 8 adds a new subsection (i) to section 37 of the code. The new subsection provides an increase in the $1,524 amount in the case of certain joint returns where both the husband and wife have attained age 65 before the close of the taxable year. If both spouses meet the 10-year earned income requirement and if in the case of either spouse the sum of the retirement income and of the amounts described in paragraphs (1) and (2) of section 37(d) of the code which reduce the $1,524 amount is less than $762, then the $1,524 amount is to be increased with respect to the other spouse by an amount equal to the excess of $762 over such sum. If either spouse does not meet the 10-year earned income requirement, the $1,524 amount is to be increased with respect to the other spouse by an amount equal to the excess of $762 over the amounts described in paragraphs (1) and (2) of section 37(d) of the code received by his spouse.

The House recedes with an amendment. Under the conference agreement, a husband and wife who make a joint return for the taxable year and both of whom have attained the age of 65 before the close of the taxable year may elect to determine the amount of the credit allowed by section 37(a) of the code by applying the special rules of the new section 37(i)(2). These special rules provide that (1) if either spouse meets the 10-year earned income requirement the other spouse shall be considered as also meeting that requirement, and (2) section 37(d) (relating to limitation on retirement income) shall be considered as providing that the amount of the combined retirement income of both spouses is not to exceed $2,286 less the sum of the amounts for each spouse specified in paragraphs (1) and (2) of section 37(d) (that is, amounts received in the taxable year as pensions and annuities which are excluded from gross income, and amounts representing adjustments for certain earned income received during the taxable year). Under the conference agreement, this new provision will apply to taxable years beginning after December 31, 1963.

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EFFECTIVE DATE FOR REPEAL OF REQUIREMENT THAT BASIS OF SECTION 38 PROPERTY BE REDUCED BY 7 PERCENT

Amendments Nos. 10, 11, 12, 13, 16, 17, and 18: Section 48(g) of the code requires the basis of any section 38 property (that is, property with respect to which an investment credit is allowable) to be reduced by an amount equal to 7 percent of the qualified investment with respect to such property. The bill as passed by the House repealed section 48(g) of the code, provided special rules to increase the basis of property placed in service before July 1, 1963 (the effective date of the repeal), and made conforming changes in the code. The repeal and conforming changes apply (1) in the case of property placed in service after June 30, 1963, with respect to taxable years ending after such date, and (2) in the case of property placed in service before July 1, 1963, with respect to taxable years beginning after June 30, 1963.

Senate amendments Nos. 10, 11, 12, 13, 16, 17, and 18 change the "June 30, 1963" and "July 1, 1963" dates to "December 31, 1963" and "January 1, 1964", respectively, for purposes of both the effective date provisions and the special rules relating to property placed in service before the effective date.

The House recedes.

GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

Amendment No. 20: The bill as passed by the House added a new section 79 to the code. In general, the new section 79 requires an employee to include in gross income for the taxable year an amount equal to the cost of group-term life insurance on his life under policies carried by his employers, but only to the extent that such cost exceeds the sum of (1) the cost of so much of such insurance as does not exceed $30,000 of such protection, and (2) the amount (if any) paid by the employee toward the purchase of the insurance.

Senate amendment No. 20 in effect increases the $30,000 amount referred to above to $70,000.

The House recedes with an amendment. Under the conference agreement the new section 79 of the code requires an employee to include in gross income for the taxable year an amount equal to the cost of group-term life insurance on his life under policies carried by his employers, but only to the extent that such cost exceeds the sum of (1) the cost of $50,000 of such insurance, and (2) the amount (if any) paid by the employee toward the purchase of such insurance. In providing for the inclusion, to the extent specified, in a taxpayer's income of certain amounts representing the cost of group-term life insurance, it is not intended that such insurance include the death benefits in so-called travel insurance or accident and health policies where such policies do not provide general death benefits.

Amendment No. 21: Under the bill as passed by the House the cost of group-term life insurance on the life of an employee provided during any period was to be determined on the basis of uniform premiums (computed on the basis of 5-year age brackets); except that, at the election of the employer with respect to any employee, the cost was to be determined on the basis of the actual average premium cost under the policy for the ages included within the age bracket which would be applicable to the employee but for the election.

Senate amendment No. 21 deletes the election (policy cost method) so that the cost is to be determined in all cases under the uniform premium method.

The House recedes. It is the understanding of the conferees that the Treasury Department will study the table of premiums at attained ages contained in the committee reports on the bill to see whether this table should not be replaced by a table which reflects the most recent mortality experience and which may possibly make some allowance for expense factors.

Amendment No. 23: The bill as passed by the House added a new section 218 to the code to provide a deduction in the case of certain employees where group-term life insurance in excess of $30,000 is provided under policies carried by his employers. The deduction in the case of any employee was to be an amount equal to the excess (if any) of (1) the amount paid by the employee toward the purchase of such insurance in excess of $30,000, over (2) the cost of such insurance in excess of $30,000 (such cost to be determined in a specified manner).

Senate amendment No. 23 strikes out this provision.

The House recedes.

Amendments Nos. 25 and 26: Under the bill as passed by the House, the cost of group-term life insurance included in the income of the employee under the new section 79 was not excluded from income tax withholding. Under Senate amendment No. 25, no part of the cost of group-term life insurance is to be subject to income tax withholding. Senate amendment No. 26 adds a new section 6052 to the code (1) to require the employer to file an information return setting forth the cost of such insurance, to the extent such cost is includible in the gross income of the employee, and (2) to furnish a statement to the employee showing the cost shown on the return. This amendment also makes conforming changes in section 6678 of the code, relating to penalty for failure to furnish statements.

The House recedes with a clerical amendment.

Amendment No. 29: The new section 79(b) of the code provides exceptions to the general rule of section 79(a) which requires an employee to include in gross income a portion of the cost of certain group-term life insurance. Under section 79(b)(2)(B), the general rule is not to apply to the cost of any portion of the group-term life insurance on the life of an employee provided during part or all of the taxable year of the employee under which a person described in section 170(c) of the code (relating to definition of charitable contributions) is the sole beneficiary. The effect of Senate amendment No. 29 is to treat the insurance contract as satisfying this condition for the period beginning January 1, 1964, and ending April 30, 1964, in the case of a taxable year beginning before May 1, 1964, if the condition is satisfied for the portion after April 30, 1964, of the employee's first taxable year ending after such date.

The House recedes.

INCLUSION IN GROSS INCOME OF REIMBURSED MEDICAL EXPENSES TO THE EXTENT THAT THE REIMBURSEMENT EXCEEDS THE EXPENSES

Amendment No. 30: Section 204 of the bill as passed by the House added a new section 80 to the code. The new section 80 required that amounts received through accident or health insurance for medi-

cal expenses be included in gross income to the extent the aggregate of such amounts received for any personal injury or sickness exceeds the aggregate amount of the medical expenses incurred by the taxpayer for such injury or sickness.

Senate amendment No. 30 strikes out this section of the bill.

The House recedes.

AMOUNTS RECEIVED UNDER WAGE CONTINUATION PLANS

Amendment No. 31: Section 105(d) of the code (relating to wage continuation plans) provides (subject to a $100 weekly rate limitation) that gross income does not include amounts received as accident or health insurance if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injury or sickness. Under existing law, in the case of a period during which the employee is absent from work on account of sickness, the exclusion from gross income does not apply to amounts (sick pay) attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least 1 day during such period.

Under the bill as passed by the House, the exclusion from gross income was not to apply to amounts (sick pay) attributable to the first 30 calendar days in any period of absence from work on account of personal injury or sickness. Senate amendment No. 31 has the same effect as the bill as passed by the House where the amounts (sick pay) received exceed 75 percent of the regular weekly rate of wages of the employee. Under the Senate amendment, if the amounts (sick pay) received are less than 75 percent of the regular weekly rate of wages of the employee, the exclusion from gross income is not to apply to amounts attributable to the first 7 calendar days in the period of absence from work unless the employee is hospitalized on account of sickness for at least 1 day during such period.

The House recedes with an amendment which provides that if the amounts (sick pay) received are at a rate not exceeding 75 percent of the employee's regular weekly rate of wages, the exclusion from gross income is to apply to amounts attributable to the first 30 calendar days of the period of absence to the extent of a weekly rate of $75, but is not to apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of personal injuries or sickness for at least 1 day during such period.

DENIAL OF DEDUCTIONS FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

Amendment No. 32: Section 207 of the bill as passed by the House amended section 164 of the code (relating to deduction of taxes) to provide for the allowance of a deduction for those State, local, and foreign taxes listed in the bill. Senate amendment No. 32 adds to the list:

(1) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels; and

(2) State and local taxes on the registration or licensing of highway motor vehicles and on licenses for the operation of highway motor vehicles.

The House recedes with an amendment. Under the conference action, State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels will remain deductible. However, State and local taxes on the registration or licensing of highway motor vehicles and on licenses for the operation of highway motor vehicles will no longer be deductible (unless paid or accrued in carrying on a trade or business or an activity described in sec. 212 of the code).

Amendment No. 35: In amending section 164 of the code, the bill as passed by the House eliminated the deduction permitted by existing section 164(b)(5)(B) of the code for certain taxes assessed against local benefits levied by special taxing districts described in such section. The effect of Senate amendment No. 35 is to continue the allowance of the deduction for such taxes if the special taxing district was in existence on December 31, 1963, and the taxes are levied for the purpose of retiring indebtedness existing on such date.

The House recedes.

CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS

Amendment No. 36: Under existing section 170(b)(1)(C) of the code, an individual is allowed an unlimited charitable contribution deduction if in the taxable year, and in 8 of the 10 preceding taxable years, the charitable contributions and the income taxes paid by the taxpayer during such year exceed 90 percent of his taxable income computed without deduction for charitable contributions, personal exemptions, and net operating loss carrybacks. Under existing law, the unlimited charitable contribution deduction is computed by reference to charitable contributions to those organizations to which the general 20-percent limitation applies, whether or not those organizations are ones to which the additional 10-percent limitation also applies.

This amendment redesignates subparagraph (D) of section 170(b)(1) of the code as subparagraph (E) and inserts a new subparagraph (D) which provides, in effect, that if the taxable year begins after December 31, 1963—

(1) section 170(b)(1)(C) shall apply only at the election of the taxpayer; and

(2) in determining whether the 90-percent requirement is satisfied in the taxable year and in 8 of the 10 preceding taxable years, the amount of the charitable contributions for the taxable year (and for all prior taxable years beginning after December 31, 1963) is to be determined without the application of section 170(b)(5) of the code (carryover of certain excess contributions by individuals, added by Senate amendment No. 37) and solely by reference to charitable contributions described in section 170(b)(1)(A) of the code, as amended by section 209(a) of the bill (i.e., contributions to those organizations to which the additional 10-percent limitation applies).

If the taxpayer elects to have section 170(b)(1)(C) apply for the taxable year, then for such taxable year the deduction under section 170(a) of the code applies only with respect to charitable contributions to those organizations to which the additional 10-percent limitation applies. In addition, no amount of charitable contributions made in the taxable year or any prior taxable year may be treated

under the new section 170(b)(5) as having been made in the taxable year or in any succeeding taxable year.

The House recedes with amendments. Under the conference agreement, section 170 of the code is amended by inserting after subsection (f) (added by subsec. (e) of sec. 209 of the bill) a new subsection (g).

Paragraph (1) of such new subsection (g) provides that if the taxable year begins after December 31, 1963—

(A) section 170(b)(1)(C) shall apply only at the election of the taxpayer; and

(B) in determining whether the 90-percent requirement is satisfied in the taxable year and in 8 of the 10 preceding taxable years, the amount of the charitable contributions for the taxable year (and for all prior taxable years beginning after December 31, 1963) is to be determined without the application of section 170(b)(5) of the code (carryover of certain excess contributions by individuals, added by Senate amendment No. 37) and solely by reference to the charitable contributions which are described in paragraph (2) of new subsection (g).

If the taxpayer elects to have section 170(b)(1)(C) apply for the taxable year, then for such taxable year, the deduction under section 170(a) of the code applies only with respect to charitable contributions which are described in paragraph (2) of new subsection (g). In addition, no amount of charitable contributions made in the taxable year or any prior taxable year may be treated under section 170(b)(5) as having been made in the taxable year or in any succeeding taxable year.

Under the conference agreement, the charitable contributions, which are referred to in paragraph (1) and described in paragraph (2) of new subsection (g), which qualify for application of the unlimited charitable contribution deduction are—

(A) any charitable contribution described in section 170(b)(1)(A) of the code;

(B) any charitable contribution, not described in section 170(b)(1)(A) of the code, to an organization described in section 170(c)(2) of the code (certain organizations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals) substantially more than half of the assets of which is devoted directly to, and substantially all of the income of which is expended directly for, the active conduct of the activities constituting the purpose or function for which it is organized and operated (as distinguished from making contributions to other organizations organized and operated for such purpose or function);

(C) any charitable contribution, not described in section 170(b)(1)(A) of the code, to an organization described in section 170(c)(2) of the code which meets the requirements of new subsection (g)(3) with respect to such charitable contribution; and

(D) any charitable contribution taken into account under existing section 170(b)(1)(C) of the code payment of which is made on or before the date of the enactment of the bill.

Under the conference agreement, a contribution to an organization which is referred to in new subsection (g)(2)(C) qualifies only if such

organization meets the two requirements described in new subsection (g)(3) with respect to such contribution. The first of such requirements is that—

(A) not later than the close of the third year after the organization's taxable year in which the contribution is received (or before such later time as the Secretary of the Treasury or his delegate may allow upon good cause shown by such organization), such organization expends an amount equal to at least 50 percent of such contribution for—

(i) the active conduct of the activities constituting the purpose or function for which it is organized and operated (as distinguished from making contributions to other organizations organized and operated for such purpose or function),

(ii) assets which are directly devoted to such active conduct,

(iii) contributions to organizations which are described in section 170(b)(1)(A) of the code or in paragraph (2)(B) of the new subsection (g), or

(iv) any combination of the foregoing.

If an amount expended as provided in subparagraph (A) is used to qualify any contribution under this 50-percent test, to the extent so used such amount may not be used as an expenditure for purposes of qualifying another contribution under subparagraph (A), whether such other contribution was made by the same donor or by another donor.

The second of such requirements with respect to such contribution is that—

(B) for the period beginning with the beginning of the taxable year in which such contribution is received and ending with the close of the taxable year in which the 50-percent test is satisfied with respect to such contribution, such organization expends all of its net income (determined without regard to capital gains and losses) for the purposes described in clauses (i), (ii), (iii), and (iv) of paragraph (3)(A).

If the organization has shown, to the satisfaction of the Secretary of the Treasury or his delegate, that good cause exists for extending the period during which the organization must expend an amount equal to 50 percent of the contribution in question, and the Secretary or his delegate allows such an extension, the requirement that the organization must expend all of its net income applies with respect to the organization's net income for the period beginning with the beginning of the taxable year in which such contribution is received and ending with the close of the taxable year in which it expends an amount equal to 50 percent of such contribution. Thus, for example, if the Secretary of the Treasury or his delegate extends the time within which an organization may expend an amount equal to at least 50 percent of a contribution until the close of the fifth taxable year after the organization's taxable year in which the contribution is received and the 50-percent test is satisfied during such fifth year, the requirement of subparagraph (B) is satisfied only if the net income for the 6-year period is expended as required by subparagraph (B). On the other hand, if the 50-percent test is satisfied during the taxable year in which the contribution is received, the requirement of subparagraph

(B) is satisfied if the net income for such taxable year is expended as required by subparagraph (B).

Under the conference agreement, subsection (g)(3) also provides the taxpayer with an election (to be exercised in accordance with regulations prescribed by the Secretary of the Treasury or his delegate) with respect to contributions made by him to an organization referred to in subsection (g)(2)(C). If the taxpayer so elects with respect to contributions made by him to such an organization, then, in applying the expenditure of income requirement with respect to contributions made by him to such organization during his taxable year for which such election is made and during all his subsequent taxable years, amounts expended by the organization after the close of any of its taxable years and on or before the 15th day of the third month following the close of such taxable year shall be treated as expended during such taxable year.

Under the conference agreement, for the contribution to qualify under section 170(b)(1)(C) of the code an additional requirement, as described in new subsection (g)(4) (disqualifying transactions), must be met by an organization referred to in new subsection (g)(2) (B) or (C). An organization shall be an organization referred to in new subsection (g)(2) (B) or (C) only if at no time during the period consisting of the organization's taxable year in which the contribution is received, its 3 preceding taxable years, and its 3 succeeding taxable years, such organization—

(A) lends any part of its income or corpus to;

(B) pays compensation (other than reasonable compensation for personal services actually rendered) to;

(C) makes any of its services available on a preferential basis to;

(D) purchases more than a minimal amount of securities or other property from; or

(E) sells more than a minimal amount of securities or other property to,

the donor of such contribution, any member of his family (as defined in section 267(c)(4) of the code), any employee of the donor, any officer or employee of a corporation in which he owns (directly or indirectly) 50 percent or more in value of the outstanding stock, or any partner or employee of a partnership in which he owns (directly or indirectly) 50 percent or more of the capital interest or profits interest. An exception to this provision makes it inapplicable to transactions which occurred on or before the date of the enactment of the bill.

Amendment No. 37: This amendment adds a new paragraph (5) to section 170(b) of the code to provide a 5-year carryover of certain charitable contributions made by individuals in taxable years beginning after December 31, 1963, where the amount of the contributions exceeds 30 percent of the taxpayer's adjusted gross income (computed without regard to net operating loss carrybacks). Under the amendment, the amount carried from a taxable year (and the amount thereof treated as paid in a succeeding taxable year) is determined solely by reference to charitable contributions to those organizations to which the additional 10-percent limitation applies.

The House recedes.

Amendment No. 41: The bill as passed by the House added a new subsection (f) to section 170 of the code to provide, in general, that payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in (and rights to the actual possession or enjoyment of) the property have expired or are held by persons other than the taxpayer (or certain related parties). The bill as passed by the House excepted from this rule any charitable contribution where the sole intervening interest or right is a nontransferable life interest reserved by the donor (or donors in the case of a joint gift by husband and wife). Senate amendment No. 41 strikes out this exception.

The House recedes on this amendment, but under the conference action on Senate amendment No. 42, the exception in the bill as passed by the House is restored with respect to transfers of future interests before July 1, 1964.

Amendment No. 42: Senate amendment No. 42 relates to the effective dates for the amendments made by the bill to section 170 of the code. In the case of individuals, the effective dates are the same as provided by the bill as passed by the House.

Under the bill as passed by the House, the amendments providing a 5-year carryover of charitable contributions made by corporations applied with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the code) in taxable years beginning after December 31, 1963. Under Senate amendment No. 42, the amendments are to apply to taxable years beginning after December 31, 1963, with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the code) in taxable years beginning after December 31, 1961.

The House recedes with an amendment (see discussion of Senate amendment No. 41).

LOSSES ARISING FROM EXPROPRIATION OF PROPERTY BY GOVERNMENTS OF FOREIGN COUNTRIES

Amendment No. 43: In general, the effect of this amendment is to permit a taxpayer to elect (for any taxable year ending after December 31, 1958) a 10-year carryover under section 172 of the code (relating to net operating loss deduction) of the portion of the net operating loss for such year attributable to a foreign expropriation loss for such year in lieu of the existing 3-year carryback and 5-year carryover. The 10-year carryover is not to apply unless the foreign expropriation loss equals or exceeds 50 percent of the net operating loss. The term "foreign expropriation loss" is defined to mean, for any taxable year, the sum of the losses sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing. For this purpose, a debt which becomes worthless is to be treated as a loss to the extent of any deduction allowed under section 166(a) of the code.

The amount of any loss taken into account in determining a foreign expropriation loss may not exceed the taxpayer's adjusted basis for the property or bad debt in question since the foreign expropriation loss must arise from a loss described in section 165 of the code or a bad debt described in section 166; in both of these cases the deduction

allowed may not exceed the adjusted basis for purposes of the sale or other disposition of the property.

If a taxpayer makes the election for a taxable year ending before January 1, 1964, special rules are provided (with respect to any year affected by the election) to extend to the close of December 31, 1965, the time for making or changing any choice or election under sections 901 through 905 of the code (relating to foreign tax credit) and to extend to the close of December 31, 1968, the time for assessing deficiencies and filing claims for refund or credit of overpayments.

The House recedes with a technical amendment.

CARE OF DEPENDENTS

Amendment No. 46: The bill as passed by both the House and the Senate amends section 214 of the code (relating to deduction for expenses for care of certain dependents). Under the bill as passed by the House, section 214(b)(1) limited the deduction under section 214(a) for any taxable year to $600, except that the $600 limit was to be increased (to an amount not above $900) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had two or more dependents (within the meaning of amended sec. 214(d)(1) of the code). In the case of a woman who is married, the increase in the limitation applied only for a period during which her husband is incapable of self-support because mentally or physically defective.

The effect of Senate amendment No. 46 is to retain the $900 amount for a period during which the taxpayer had two dependents, to increase the $900 amount to $1,000 for a period during which the taxpayer had three or more dependents, and to omit the provision which would limit the application of these new amounts in the case of married women.

The House recedes with an amendment which retains the $900 amount for a period during which the taxpayer had two or more dependents and omits the provision which would limit the application of this new amount in the case of married women.

Amendment No. 47: Under the bill as passed by the House, section 214(b) further provided, in the case of a woman who is married and in the case of a husband whose wife is incapacitated, that the deduction otherwise allowable under section 214(a)—

(1) would not be allowed unless the couple files a joint return; and

(2) would be reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $4,500.

These conditions did not apply in certain specified situations. The effect of the Senate amendment No. 47 is to retain these conditions and exceptions, except that the Senate amendment substitutes $7,000 for the $4,500 amount.

The House recedes with an amendment which provides that this amount will be $6,000.

DEDUCTION FOR POLITICAL CONTRIBUTIONS

Amendment No. 53: This amendment adds a new section 218 to the code. Section 218(a) provides that in the case of an individual, there shall be allowed as a deduction any political contribution pay-

ment of which is made by the taxpayer within the taxable year. Section 218(b) limits the deduction to $50 for any taxable year, except that in the case of a joint return of a husband and wife the limit is $100.

The Senate recedes.

100-PERCENT DIVIDENDS-RECEIVED DEDUCTION FOR MEMBERS OF ELECTING AFFILIATED GROUPS

Amendment No. 54: This amendment adds a new section to the bill which amends section 243 of the code (relating to the deduction for certain dividends received by corporations) to provide a 100-percent deduction in the case of "qualifying dividends", and makes conforming technical amendments.

As amended, section 243(b)(1) defines the term "qualifying dividends" to mean dividends received by a corporation which (at the close of the day the dividends are received) is a member of the same affiliated group of corporations (as defined in sec. 243(b)(5)) as the corporation distributing the dividends, if (1) such affiliated group has made an election under section 243(b)(2) which is effective for the taxable years of its members which include such day; and (2) the dividends are distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963, with respect to which two requirements are satisfied. First, the distributing corporation and the recipient corporation must have been members of such affiliated group on each day of such taxable year. Second, an election under section 1562 (relating to election of multiple surtax exemptions) must not be effective for such taxable year.

Section 243(b)(2) prescribes rules for the making of an election and the taxable years to which it applies. Under section 243(b)(3), if an election by an affiliated group is effective with respect to a taxable year of the common parent corporation, then under regulations prescribed by the Secretary of the Treasury or his delegate—

(1) no member of such affiliated group may consent to an election under section 1562 for such taxable year;

(2) the members of such group will be treated as one taxpayer for purposes of making the elections under section 901(a) (relating to allowance of foreign tax credit) and section 904(b)(1) (relating to election of overall limitation); and

(3) the members of such affiliated group will be limited to (i) one $100,000 minimum accumulated earnings credit under section 535(c) (2) or (3); (ii) one $100,000 limitation for exploration expenditures under section 615 (a) and (b); (iii) one $400,000 limitation for exploration expenditures under section 615(c)(1); (iv) one $25,000 limitation on small business deductions of life insurance companies under sections 804(a)(4) and 809(d)(10); and (v) one $100,000 exemption for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax.

Section 243(b)(4) provides for the termination of an election under section 243(b)(2) either by the filing by the group of a termination of the election or by the filing of a statement by a new member of the group that it does not consent to the election.

Section 243(b)(5) provides that the term "affiliated group" has the meaning assigned to it by section 1504(a) of the code except that for

purposes of the 100-percent dividends received deduction insurance companies subject to taxation under section 802 or 821 of the code are not to be excluded by section 1504(b)(2) from a group and are not to be considered under section 1504(c) as a separate group. Section 243(b)(6) provides special rules for insurance companies.

The amendments providing for the 100-percent dividends received deduction are to apply with respect to dividends received in taxable years ending after December 31, 1963.

The House recedes with a clerical amendment.

INTEREST ON LOANS INCURRED TO PURCHASE CERTAIN INSURANCE AND ANNUITY CONTRACTS

Amendment No. 56: The bill as passed by the House amended section 264 of the code to provide that, under certain circumstances, no deduction is allowed for interest on loans incurred or continued to purchase or carry certain life insurance, endowment, or annuity contracts. This new provision was to apply only in respect of contracts purchased after August 6, 1963. Under the Senate amendment No. 56 this new provision applies only in respect of contracts purchased after December 31, 1963.

The Senate recedes.

INTEREST ON INDEBTEDNESS INCURRED OR CONTINUED TO PURCHASE OR CARRY TAX-EXEMPT BONDS

Amendment No. 57: Section 265(2) of the code provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations (other than certain obligations of the United States) the interest on which is wholly exempt from income tax. Under Senate amendment No. 57, a new sentence is added to section 265(2) to provide that, in applying the preceding sentence to a financial institution (other than a bank) which is subject to the banking laws of the State in which such institution is incorporated, interest—

(1) on face-amount certificates (as defined in sec. 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. 80a–2)) issued by the institution; and

(2) on amounts received by such institution to be applied toward the purchase of such face-amount certificates to be issued by the institution—

is not to be considered as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from income tax to the extent that the average amount of such obligations held by such institution during the taxable year (as determined under regulations prescribed by the Secretary of the Treasury or his delegate) does not exceed 25 percent of the average of the total assets of the institution during the taxable year (as so determined). The new provision is to apply with respect to taxable years ending after the date of the enactment of the bill.

The House recedes with amendments. Under the conference agreement, the new sentence added to section 265(2) of the code by the Senate amendment is to apply only with respect to interest on face-amount certificates, and on amounts received toward the purchase of such certificates, issued by a face-amount certificate company

(registered under the Investment Company Act of 1940), and the percentage contained in the new sentence is reduced to 15 percent. In providing that the financial institutions specified in this provision are not to be denied interest deductions under section 265(2) of the code to the extent that the average amount invested by such an institution in tax-free obligations does not exceed 15 percent of the average of its total assets, it is not intended to imply that an interest deduction is to be denied because of investments in excess of the specified 15-percent level if the taxpayer establishes that indebtedness was not "incurred or continued to purchase or carry" these excess obligations. Nor is it intended that any inference with respect to years before the effective date of this provision be drawn from the enactment of this provision.

ALLOCATION OF CERTAIN TRAVELING EXPENSES

Amendment No. 58: Section 274(c) of the code provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. Such provision, however, does not apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or to an activity specified in section 212 is less than 25 percent of the total time away from home on such travel. Senate amendment No. 58 strikes out subsection (c) of section 274 of the code, effective with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

The House recedes with an amendment which, in effect, retains section 274(c) of the code but limits its application to foreign travel. Under the conference agreement, section 274(c) will only apply to an individual's travel outside the United States away from home. Travel from one point in the United States to another point in the United States is not to be considered travel outside the United States, even though it may constitute a portion of the trip in which the taxpayer travels to a point outside the United States. Section 274(c), as amended, will not apply to the expenses of any travel outside the United States away from home, if such travel does not exceed 1 week, or if the portion of the time of travel outside the United States away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time on such travel. Section 274(c), as amended, will apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

ACQUISITION OF STOCK IN EXCHANGE FOR STOCK OF CORPORATION WHICH IS IN CONTROL OF ACQUIRING CORPORATION

Amendment No. 59: Under existing section 368(a)(1)(B) of the code, the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation qualifies as a

"reorganization" if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). Under Senate amendment No. 59, section 368(a)(1)(B) is amended to permit an acquiring corporation to exchange either its voting stock or the voting stock of a corporation which is in control of the acquiring corporation for the stock of another corporation. The amendment also makes technical and conforming changes. The amendments apply with respect to transactions after December 31, 1963, in taxable years ending after such date.

The House recedes with a clerical amendment.

RETROACTIVE QUALIFICATION OF CERTAIN UNION-NEGOTIATED MULTIEMPLOYER PENSION PLANS

Amendment No. 60: Section 401 of the code relates to qualified pension, profit-sharing, and stock bonus plans. Senate amendment No. 60 inserts a new subsection (i) in section 401.

The new subsection (i) applies to a trust forming part of a pension plan which has been determined by the Secretary of the Treasury or his delegate to constitute a qualified trust under section 401(a), and to be exempt from taxation under section 501(a), for a period beginning after contributions were first made to or for such trust. The new subsection (i) provides that where such a trust meets certain conditions, then it shall be considered as having constituted a qualified trust under section 401(a), and as having been exempt from taxation under section 501(a), for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to the new subsection) a qualified trust.

The conditions referred to in the preceding paragraph require that it be shown to the satisfaction of the Secretary of the Treasury or his delegate that: (1) Such trust was created pursuant to a collective bargaining agreement between employee representatives and two or more employers who are not related (determined under regulations prescribed by the Secretary of the Treasury or his delegate); (2) any disbursements made prior to the period for which the trust was determined to be qualified (without regard to the new subsection) substantially comply with the terms of the trust (and plan) as so qualified; and (3) prior to the period for which the trust was determined to be qualified (without regard to the new subsection) contributions were not used in a manner which would jeopardize the interests of the beneficiaries.

The new subsection (i) is to apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954.

The House recedes with a clerical amendment.

QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS

Amendment No. 61: This amendment adds a new section to the bill, relating to qualified pension, etc., plan coverage for employees of certain subsidiary employers.

Employees of foreign subsidiaries covered by social security agreements

Subsection (a) of the new section adds a new section 406 to part I of subchapter D of chapter 1 of the code.

(*a*) *Treatment as employees of domestic corporation.*—The new section 406(a) sets forth the rules relating to the treatment of certain employees of foreign subsidiaries who are covered under a social security agreement described in section 3121(l) of the code, entered into at the request of the domestic corporation, as employees of such domestic corporation. The new section 406(a) only applies in the case of a plan established and maintained by a domestic corporation which is a pension, profit-sharing, or stock bonus plan described in section 401(a) of the code, an annuity plan described in section 403(a) of the code, or a bond purchase plan described in section 405(a) of the code. The new section 406(a) provides that in the case of such a plan an individual who is a citizen of the United States and who is also an employee of a foreign subsidiary (as defined in sec. 3121(l)(8) of the code) of the domestic corporation shall be treated as an employee of such domestic corporation if certain requirements are satisfied.

The first of the requirements of the new section 406(a) is that the domestic corporation has entered into an agreement described in section 3121(l) of the code, relating to agreements entered into by domestic corporations with respect to foreign subsidiaries, and such agreement covers the foreign subsidiary of the domestic corporation in which the individual is employed.

The second requirement is that the qualified plan of the domestic employer must expressly provide coverage for the U.S. citizen employees of all foreign subsidiaries which are covered under the agreement described in section 3121(l) of the code which has been entered into by the domestic corporation.

The third requirement for qualification of an individual as an employee is that contributions under a funded plan of deferred compensation (whether or not such plan is a qualified plan) are not provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary.

(*b*) *Special rules for application of section 401*(*a*).—The new section 406(b) provides certain special rules for the application of section 401(a) of the code in the case of a plan which covers an individual who is treated as an employee of a domestic corporation under the new section 406(a).

Paragraph (1) of such section 406(b) provides certain rules regarding the application of section 401(a) (3)(B) and (4) of the code in the case of a plan which covers such an individual. Paragraph (1)(A) of section 406(b) provides that if such an individual is an officer, shareholder, or person whose principal duties consist in supervising the work of other employees of a foreign subsidiary of such domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation. Paragraph (1)(B) of section 406(b) provides that the determination of whether an individual who is treated as an employee under the new section 406(a) is a highly compensated employee for purposes of section 401(a) (3)(B) and (4) of the code is made by treating such individual's total compensation (as computed in accordance with the provisions of par. (2) of sec. 406(b)) as compensation paid by the domestic corporation and by determining

such individual's status as a highly compensated employee with regard to such domestic corporation.

Paragraph (2) of the new section 406(b) sets forth the rules regarding determination of the compensation of an individual who is treated as an employee of a domestic corporation under section 406(a) of the code. Such rules are applicable whenever the compensation of such an individual is to be determined for the purpose of determining whether the plan satisfies the requirements for qualification set forth in section 401(a). Paragraph (2)(A) of section 406(b) provides that, for the purpose of applying section 401(a)(5) with respect to such an individual, his total compensation is the remuneration paid to him by the foreign subsidiary which would constitute his total compensation if his services had been performed for the domestic corporation treated as his employer. In addition, such paragraph (2)(A) provides that the portion of the individual's total compensation which constitutes his basic or regular rate of compensation shall be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Paragraph (2)(B) of section 406(b) provides that an individual who is treated as an employee under section 406(a) shall be treated as having paid the amount paid by such domestic corporation which is equivalent to the tax imposed by section 3101 of the code (relating to the tax imposed on employees) with respect to such individual.

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—Existing sections 402(a)(2) and 403(a)(2) of the code provide capital gains treatment for certain distributions after an employee's separation from service. The new section 406(c) provides that for purposes of applying section 402(a)(2) and section 403(a)(2) of the code with respect to an individual who is treated as an employee of a domestic corporation under section 406(a), such individual shall not be treated as separated from the service solely by reason of the fact that—

(1) the agreement entered into by such domestic corporation under section 3121(l) which covers the employment of such individual is terminated under the provisions of such section;

(2) such individual becomes an employee of a foreign subsidiary (as defined in sec. 3121(l)(8)) with respect to which an agreement described in section 3121(l) does not apply;

(3) such individual ceases to be an employee within the meaning of section 406(a) and becomes an employee of another corporation controlled by the domestic corporation; or

(4) the provision of the plan described in section 406(a)(2) is terminated.

(*d*) *Deductibility of contributions.*—The new section 406(d) relates to the deductibility of contributions made on behalf of an individual who is treated as an employee of a domestic corporation by reason of the provisions of section 406(a).

Paragraph (1) of the new section 406(d) provides that, for purposes of applying sections 404 and 405(c) with respect to contributions made to a qualified plan on behalf of an individual who is treated as an employee of a domestic corporation under section 406(a), no domestic corporation is allowed a deduction.

Paragraph (2) of the new section 406(d) provides that the amount which would be deductible under section 404 or 405(c) by the domestic

corporation if the individual who is an employee within the meaning of section 406(a) were its own employee is to be allowed as a deduction to the foreign subsidiary.

Paragraph (3) of the new section 406(d) provides that for the purpose of computing the amount deductible under section 404 or 405(c) any reference to compensation shall be considered to be a reference to the total compensation of such individual determined with the application of the rules set forth in the new section 406(b)(2).

The new section 406(d) also provides that any amount deductible by a foreign subsidiary under this section shall be deductible for its taxable year with or within which the taxable year of the domestic corporation ends.

(*e*) *Treatment as employee under related provisions.*—The new section 406(e) provides that an individual who is treated as an employee of a domestic corporation under the new section 406(a) is also to be treated as an employee of the domestic corporation with respect to certain related provisions dealing with the tax treatment of employees under the qualified plan.

Employees of domestic subsidiaries engaged in business outside the United States

Subsection (b) of the new section added by the Senate amendment adds a new section 407 to part I of subchapter D of chapter 1 of the code.

(*a*) *Treatment as employees of domestic parent corporation.*—The new section 407(a) sets forth the requirements which must be satisfied for a U.S. citizen who is employed by a domestic subsidiary engaged in business outside the United States to be treated as an employee of the domestic parent corporation.

Paragraph (1) of section 407(a) provides that for purposes of applying part I of subchapter D of chapter 1 of the code, with respect to a qualified plan described in either section 401(a), 403(a), or 405(a), of a domestic parent corporation, an individual who is a citizen of the United States and an employee of a domestic subsidiary (as defined in par. (2) of sec. 407(a)) of a domestic parent corporation shall be treated as an employee of the domestic parent corporation if two requirements are satisfied. The first of these requirements is that the plan of the domestic parent corporation must expressly provide coverage for U.S.-citizen employees of every domestic subsidiary (as defined in par. (2) of sec. 407(a)). The second requirement is that contributions must not be provided for the employee by any other person under a funded plan of deferred compensation (whether or not such plan is a qualified plan).

Paragraph (2) of the new section 407(a) provides certain definitions for purposes of section 407. Paragraph (2)(A) of section 407(a) defines the term "domestic subsidiary" for purposes of section 407. Such paragraph (2)(A) sets forth three requirements which must be satisfied in order for a domestic corporation to be classified as a "domestic subsidiary". First, the domestic parent corporation must own 80 percent or more of the outstanding voting stock of the subsidiary corporation. Second, 95 percent or more of the subsidiary corporation's gross income for the 3-year period immediately preceding the close of the taxable year of such subsidiary which ends on or before the close of the taxable year of the domestic parent corporation

(or for such part of such period during which the corporation was in existence) must be derived from sources without the United States. The third requirement is that 90 percent or more of the subsidiary corporation's gross income for such period (or such part) must be derived from the active conduct of a trade or business.

Paragraph (2)(B) of section 407(a) defines the term "domestic parent corporation" for purposes of section 407. A domestic parent corporation for purposes of such section is the domestic corporation which owns 80 percent or more of the outstanding voting stock of a domestic subsidiary (as defined in paragraph (2)(A)).

(*b*) *Special rules for application of section 401(a).*—The new section 407(b) provides special rules for the application of section 401(a). The rules are substantially the same as those prescribed in the new section 406 (b)(1) and (2)(A), except that the provisions of section 407(b) relate to individuals who are employees within the meaning of section 407(a).

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—The new section 407(c) relates to certain occasions when the termination of the status as an employee within the meaning of section 407 shall not be treated as separation from service for purposes of sections 402(a)(2) and 403(a)(2) of the code. The new section 407(c) provides that an individual who is an employee of a domestic subsidiary but who is treated as an employee of a domestic parent corporation under the new section 407(a) shall not be considered as separated from the service of the domestic parent corporation solely by reason of the fact that—

(1) the domestic subsidiary ceases, for any taxable year, to be a subsidiary within the meaning of section 407(a)(2)(A);

(2) such individual ceases to be an employee of a domestic subsidiary corporation and becomes an employee of another corporation controlled by the domestic parent corporation; or

(3) the plan no longer contains the provision described in section 407(a)(1)(A).

(*d*) *Deductibility of contributions.*—The new section 407(d) provides rules relating to the deductibility of contributions made on behalf of an individual who is an employee within the meaning of section 407(a). These rules are substantially the same as the rules in the new section 406(d), except that the provisions of section 407 relate to contributions on behalf of employees of domestic subsidiaries.

(*e*) *Treatment as employee under related provisions.*—The substantive provisions of the new section 407(e) are the same as the new section 406(e), except that the provisions of section 407 relate to the tax treatment of employees of domestic subsidiaries.

Technical amendments

Subsection (c) of the new section added to the bill makes a conforming change in a table of sections and amends section 3121(a)(5) of the code (relating to definition of wages) and section 209(e) of the Social Security Act (relating to definition of wages) to conform these definitions to the Internal Revenue Code of 1954, as amended by the Self-Employed Individuals Tax Retirement Act of 1962.

Effective date

Subsection (d) of the new section added to the bill provides that the new sections 406 and 407 added to the code shall apply with respect to taxable years ending after December 31, 1963. The technical amendments relating to the definitions of wages are to apply to remuneration paid after December 31, 1962.

The House recedes with a clerical amendment and a technical amendment.

EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS

Amendments Nos. 64, 66, 67, 71, 74, 76, 81, 82, 83, 84, 85, 86, 87, and 88: The bill as passed both by the House and the Senate revises part II of subchapter D of chapter 1 of the code (relating to certain stock options). Under the bill as passed by the House, the revised part II was to apply to taxable years ending after June 11, 1963, and the determination as to whether an option is a qualified stock option, a restricted stock option, or an option granted under an employee stock purchase plan was (in general) to be based in part on whether the option was granted after June 11, 1963, or before June 12, 1963. These amendments change the June 11, 1963, and June 12, 1963, dates to December 31, 1963, and January 1, 1964, respectively.

The House recedes on these amendments.

Amendment No. 95: This amendment adds a special rule for determining whether options granted during the calendar year 1964 are (or may be changed during such year to become) qualified stock options. In the case of such an option, the requirements of paragraphs (1) and (2) of section 422(b) of the code (as added by the bill) are not to apply, and paragraph (1) of section 425(h) of the code is not to apply to any change in the terms of the option made before January 1, 1965, to permit such option to qualify under paragraphs (3), (4), and (5) of section 422(b). Paragraphs (1) and (2) of section 422(b) require a qualified stock option (1) to be granted pursuant to a plan which is approved by the stockholders and which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options; and (2) to be granted within 10 years from the date the plan is adopted, or the date approved by the stockholders, whichever is earlier. Paragraph (1) of section 425(h) provides that, for purposes of part II of subchapter D of chapter 1, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal is to be considered as the granting of a new option.

The House recedes.

Amendment No. 70: Under the bill as passed both by the House and Senate, section 422(b)(5) of the code provides (in general) that an option may not be a qualified stock option unless such option by its terms is not exercisable while there is outstanding a prior qualified (or restricted) stock option issued to the individual to purchase stock in the employer corporation (or certain other corporations). Under this Senate amendment, section 422(b)(5) is not to apply if (1) the new option and all outstanding qualified (or restricted) stock options referred to in section 422(b)(5) are to purchase stock of the same class in the same corporation, and (2) the price payable under each

such outstanding option (as of the date of the grant of the new option) is not more than the option price of the new option.

The House recedes with a technical amendment.

Amendment No. 91: Under the bill as passed both by the House and the Senate, section 425(h)(3) of the code defines the term "modification" to mean (subject to certain exceptions) any change in the terms of the option which gives the employee additional benefits under the option. Under this amendment, in the case of an option not immediately exercisable in full, the term "modification" is not to include a change in the terms of the option to accelerate the time at which the option may be exercised.

The House recedes.

The attention of the conferees was called to a statement in the report on this bill of the Senate Committee on Finance to the effect that the use of a general term such as "key employees" is not a sufficient description of those eligible to receive options. The conferees, after having considered the matter, have concluded that the use of the term "key employees" should be considered a sufficient description of the class of employees from among whom a board of directors or any other executive committee of a corporation may select those to whom stock options may be granted.

The bill provides that a qualified stock option plan must be approved by stockholders within a 12-month period before or after its adoption and must provide the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive such options. It is intended that the remaining requirements relating to the terms of options granted under the new provisions may be met in such options. Inconsistencies between the plan and the options should, of course, be removed but a modification by the board of directors (or other executive committee of the corporation), under a power, expressed or implied, of the board (or committee) to modify the plan to conform with the requirements of law, will be sufficient. The granting period for qualified stock options under these circumstances will not be affected by such modifications.

INSTALLMENT SALES BY DEALERS IN PERSONAL PROPERTY

Amendment No. 96: This amendment adds a new section to the bill amending section 453(a) of the code (relating to reporting of income by dealers in personal property from sales on the installment plan). Under the amendment the existing provisions of section 453(a) are continued in the new paragraph (1) and new paragraphs (2) and (3) are added.

The new paragraph (2) provides that for purposes of paragraph (1), the term "installment plan" includes any plan which provides for the payment by the purchaser for the personal property sold to him in a series of periodic installments of an agreed part or installment of the debt due the seller.

The new paragraph (3) provides that for purposes of paragraph (1), the term "total contract price" includes all charges relative to the sale of the personal property, including the time price differential which represents the amount paid or payable for the privilege of purchasing

the personal property to be paid for by the purchaser in installments over a period of time.

The amendment to section 453(a) is to apply to taxable years beginning after December 31, 1963.

The House recedes with an amendment. Under the conference agreement, a new subsection (e) is added to section 453. New section 453(e) provides that, for purposes of section 453(a) of the code (which in effect allows a dealer in personal property to return on the installment basis income from sales of personal property on the installment plan), the term "installment plan" includes a revolving credit type plan which provides that the purchaser of personal property at retail may pay for such property in a series of periodic payments of an agreed portion of the amounts due the dealer under the plan, except that such term does not include any such plan with respect to a purchaser who uses his account primarily as an ordinary charge account. The new section 453(e) is to apply in respect of sales made during taxable years beginning after December 31, 1963.

TIMING OF DEDUCTIONS AND CREDITS IN CERTAIN CASES WHERE ASSERTED LIABILITIES ARE CONTESTED

Amendment No. 97: This amendment adds a new section to the bill, relating to the timing of deductions and credits in certain cases where asserted liabilities are contested.

(*a*) *Taxable year of deduction or credit.*—Subsection (a) of the new section amends section 461 of the 1954 code (relating to general rule for taxable year of deduction) and section 43 of the 1939 code (relating to period for which deductions and credits taken) to provide that if—

(1) the taxpayer contests an asserted liability;

(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability;

(3) the contest with respect to the asserted liability exists after the time of the transfer; and

(4) but for the fact that the asserted liability is contested, a deduction or credit would be allowed for the taxable year of the transfer (or for an earlier taxable year);

then the deduction or credit shall be allowed for the taxable year of the transfer.

(*b*) *Effective dates.*—Subsection (b) of the new section provides that except as provided by subsections (c) and (d) of the new section, the amendment to the 1954 code is to apply to taxable years to which the 1954 code applies and the amendment to the 1939 code is to apply to taxable years to which the 1939 code applies.

(*c*) *Election as to transfers in taxable years beginning before January 1, 1964.*—Paragraph (1) of subsection (c) of the new section added to the bill provides that the amendments made to section 461 of the 1954 code and section 43 of the 1939 code by subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if the taxpayer elects, in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, to have such paragraph (1) apply. Such an election (1) must be made within 1 year after the date of enactment of the bill, (2) may not be revoked after the expiration of such 1-year period, and (3) shall apply to all transfers of money or

other property described in subsection (a) made in a taxable year beginning before January 1, 1964 (other than transfers described in par. (2) of subsec. (c)). In the case of any transfer to which paragraph (1) applies, the deduction or credit shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

Paragraph (2) of subsection (c) provides that paragraph (1) of subsection (c) shall not apply to any transfer if the assessment of any deficiency which would result from the application of the election in respect of such transfer is, on the date of the election under such paragraph (1), prevented by the operation of any law or rule of law.

Paragraph (3) of subsection (c) provides that if the taxpayer makes an election under paragraph (1) of subsection (c), and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or rule of law, the period within which assessment of such deficiency may be made shall not expire earlier than 2 years after the date of enactment of the bill.

(*d*) *Certain other transfers in taxable years beginning before January 1, 1964.*—Subsection (d) of the new section added to the bill provides that the amendments made to section 461 of the 1954 code and section 43 of the 1939 code by paragraphs (1) and (2), respectively, of subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if (1) no deduction or credit has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and (2) refund or credit of any overpayment which would result from the application of such amendments to such transfer is prevented by the operation of any law or rule of law. In the case of any transfer to which subsection (d) applies, the deduction or credit shall be allowed for the taxable year in which the contest with respect to such transfer is settled.

The House recedes with amendments. Under the conference agreement, the amendments to section 461 of the 1954 code (relating to general rule for taxable year of deduction) and section 43 of the 1939 code (relating to period for which deductions and credits taken) do not apply in respect of any credit against tax, and do not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

It is the understanding of the conferees that the new provisions relating to the timing of deductions in certain cases where asserted liabilities are contested do not affect the taxable year in which the taxpayer may deduct items of a nature which are properly accruable in a year before the year of payment.

INTEREST ON CERTAIN DEFERRED PAYMENTS

Amendment No. 99: Subsection (c) of section 215 of the bill as passed by the House amended section 163(b) of the code to provide that if personal services are purchased under a contract providing for installment payments of part or all of the purchase price and if the contract provides for carrying charges but the portion thereof which constitutes interest cannot be ascertained, then the payments

under the contract are treated, for purposes of the interest deduction, as if they included interest equal to 6 percent of the average unpaid balance. Senate amendment No. 99 strikes this provision from the bill.

The House recedes with an amendment. Under the conference agreement, this provision is restored to the bill but is made applicable only with respect to educational services. For this purpose, the term "educational services" is defined as meaning any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4) of the code) and which is provided for a student of such institution.

Amendment No. 100: Under the bill as passed by the House the new provisions relating to the treatment of interest on certain deferred payments (subsec. (a) of this section of the bill) were to apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. Senate amendment No. 100 provides, in addition, that the new provisions will not apply to a sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963.

The House recedes with an amendment providing that the amendments made to section 163(b)(1) of the code with respect to certain payments for educational services are to apply to payments made during taxable years beginning after December 31, 1963.

PERSONAL HOLDING COMPANIES

Amendments Nos. 102, 105, 106, and 107:

Excluded lending and finance companies.—Under the bill as passed by the House, a lending or finance company was excluded from the definition of a personal holding company if it met four requirements: (1) At least 60 percent of its ordinary gross income must be derived directly from the active and regular conduct of a lending or finance business (2) its personal holding company income (computed without regard to income qualifying under the 60-percent test; computed by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for the use of corporate property by shareholders; and computed without regard to certain income from domestic subsidiaries described in sec. 542(d)(3) of the code), plus the interest described in section 543(b)(2)(C) of the code, must not exceed 20 percent of the ordinary gross income; (3) business deductions directly allocable to the active and regular conduct of its lending or finance business must equal or exceed the sum of 15 percent of its ordinary gross income up to $500,000 plus 5 percent of its ordinary gross income between $500,000 and $1,000,000; and (4) loans to substantial shareholders must not exceed $5,000 in principal amount. Senate amendment No. 102 deletes the provision that interest described in section 543(b)(2)(C) be included with the corporation's personal holding company income in applying the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B) which is described in clause (2) of the preceding sentence.

The House recedes on Senate Amendment No. 102.

Under the bill as passed by the House, section 542(d)(1)(A) of the code defined a lending or finance business, generally, as a business of

making loans, or purchasing or discounting accounts receivable, notes, or installment obligations. Senate amendment No. 105 amends the definition of a lending or finance business in section 542(d)(1) to include therein the business of rendering services or making facilities available to another member of the same affiliated group (as defined in sec. 1504) which is also in the lending or finance business. The House recedes with an amendment to Senate amendment No. 105. Under the conference agreement, the definition of a lending or finance business in section 542(d)(1) includes (1) rendering services or making facilities available in connection with the activities of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations where such activities are carried on by the corporation rendering the services or making the facilities available, and (2) rendering services or making facilities available to another corporation which is a member of the same affiliated group and is engaged in the lending or finance business, if such services or facilities are related to the lending or finance business of such other corporation.

Under the bill as passed by the House, section 542(d)(1)(B)(i) provided that the term "lending or finance business" does not include the business of making loans, or purchasing or discounting notes or installment obligations, if the remaining maturity exceeds 60 months. Senate amendment No. 106 excepts from this exclusion loans, notes, and installment obligations evidenced or secured by contracts of conditional sale, chattel mortgages, or lease agreements, arising out of the sale of goods or services in the course of the transferor's or borrower's trade or business. The House recedes with a clarifying amendment.

Under the bill as passed by the House, section 542(d)(3) of the code provided that the lawful income received by a lending company which is in the small loan business (consumer finance business) from domestic subsidiary corporations which are themselves excepted from the definition of a personal holding company under section 542(c)(6) is not included for purposes of the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B). Senate amendment No. 107 changes this provision in two respects. First, the corporation receiving such income may be any lending or finance company which meets the 60-percent requirement of section 542(c)(6)(A). It does not have to meet the requirement of being in the small loan (consumer finance) business. Second, the payor corporation may be any member of the same affiliated group (as defined in sec. 1504 of the code) as the corporation receiving such income. Thus, the corporation receiving such income is not required to be the parent corporation of the payor corporation. However, the payor corporation must still meet the requirements of section 542(c)(6). The House recedes.

Amendments Nos. 108, 109, and 111:

Personal holding company income.—Subsection (d) of this section of the bill amends section 543(a) of the code (relating to personal holding company income). It also amends section 543(b) to provide definitions of the new terms "ordinary gross income," "adjusted ordinary gross income," "adjusted income from rents," and "adjusted income from mineral, oil, and gas royalties." Subsections (a) and (b) of section 543 are the same under the bill as passed by the House and under the Senate amendments except for changes in section 543(a)(2) (relating to rents), section 543(b)(2)(A) (relating to required adjust-

ments in the amount of gross income from rents includible in adjusted ordinary gross income), and section 543(b)(4) (defining "adjusted income from mineral, oil, and gas royalties").

Rents.—Senate amendment No. 108 modifies the 10-percent test in section 543(a)(2)(B) in the bill as passed by the House to provide that adjusted income from rents which meets the 50-percent requirement of section 543(a)(2)(A) shall not be treated as personal holding company income if the sum of the consent dividends (determined under sec. 565) and the dividends paid or considered as paid (determined under secs. 562 and 563) during the taxable year by the corporation to its shareholders equals or exceeds the amount, if any, by which the corporation's personal holding company income for the taxable year (computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating copyright royalties and adjusted income from mineral, oil, and gas royalties as personal holding company income) exceeds 10 percent of the ordinary gross income as defined in section 543(b)(1). The effect of this modification in the 10-percent test applicable to rents is that this test shall be deemed to be met if the shareholders are required to include in their income as dividends an amount which is at least equal to the corporation's other personal holding company income which is in excess of 10 percent of total ordinary gross income. The House recedes.

Adjustment to rents included in adjusted ordinary gross income.—The bill as passed by the House defines, in paragraph (2) of section 543(b) of the code, the term "adjusted ordinary gross income" as the ordinary gross income adjusted as provided in subparagraphs (A), (B), and (C) of such paragraph. Senate amendment No. 109 amends subparagraph (A)(i) of section 543(b)(2) to provide that the gross income from rents derived from leases of tangible personal property which is not customarily retained by any one lessee for a period of more than 3 years shall not be reduced by allowable deductions for exhaustion, wear and tear, obsolescence, and amortization of such property. The House recedes.

Adjusted income from mineral, oil, and gas royalties.—Senate amendment No. 111 amends section 543(b)(4) of the code to specifically include production payments and overriding royalties as mineral, oil, and gas royalties for purposes of classification as personal holding company income under section 543(a). The House recedes.

Amendments Nos. 114, 116, 117, 119, 124, 129, and 131:

One-month liquidations.—The bill as passed by the House added a new subsection (g) to section 333 of the code to provide a special rule for 1-month liquidations of certain corporations. Senate amendment No. 114 amends paragraph (1) of section 333(g) to provide that it shall be applicable to corporate liquidations occurring before January 1, 1967 (instead of January 1, 1966, as in the bill as passed by the House). Senate amendments Nos. 116 and 117 provide that the capital gain treatment under section 333(g)(1)(B) shall not apply to certain earnings and profits to which the corporation succeeds after December 31, 1963 (instead of August 1, 1963). Senate amendments Nos. 119 and 124 amend paragraph (2) of section 333(g) to provide that it shall be applicable to liquidations occurring after December 31, 1966 (instead of December 31, 1965), of corporations which owe qualified indebtedness (as defined in sec. 545(c)) on January 1, 1964 (instead of on August 1, 1963). The House recedes.

Senate amendment No. 129 amends paragraph (3) of section 333(g), which describes the corporations to which paragraphs (1) and (2) of section 333(g) may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least 1 of its 2 most recent taxable years ending before December 31, 1963 (instead of the date of the enactment of the bill) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year. The Senate recedes.

Senate amendment No. 131 adds a new paragraph (4) to section 333(g) providing that if an election is made under section 333 by a qualified electing shareholder (as defined in sec. 333(c)) of a corporation and the shareholder states in such election that it is made on the assumption that the corporation is a corporation referred to in paragraph (3) of section 333(g), the election under section 333 shall have no force or effect if it is determined that the corporation is not a corporation referred to in section 333(g)(3). The House recedes.

Amendments Nos. 132, 133, 137, and 139:

Deduction for amortization of indebtedness.—The bill as passed by the House added a new subsection (c) to section 545 of the code which provides that, under certain circumstances, there shall be allowed as a deduction (in computing undistributed personal holding company income) amounts used, or amounts irrevocably set aside, to pay or retire qualified indebtedness. Senate amendment No. 133 amends proposed section 545(c)(3) to provide that the term "qualified indebtedness" includes outstanding indebtedness incurred by the taxpayer before January 1, 1964 (instead of before August 1, 1963, as in the bill as passed by the House). The House recedes.

Senate amendments Nos. 137 and 139 amend proposed paragraphs (5) and (6) of section 545(c) to provide that allowable deductions for depletion shall be taken into account to reduce the deduction allowed by section 545(c) and to reduce the qualified indebtedness under certain circumstances. The House recedes.

Senate amendment No. 132 amends proposed paragraph (2)(A) of section 545(c), which describes a category of corporations to which paragraph (1) of section 545(c) may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before December 31, 1963 (instead of the date of the enactment of the bill, as in the bill as passed by the House) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year. The Senate recedes.

Amendment No. 141:

Increase in basis with respect to certain foreign personal holding company stock or securities.—Subsection (j) of section 216 of the bill as passed by the House amended the code to provide for an increase in basis with respect to certain foreign personal holding company holdings. Such subsection (j) also contained provisions relating to the liquidation of certain foreign personal holding companies. Senate amendment No. 141 strikes out this subsection.

Under the conference agreement, the provisions of subsection (j) relating to an increase in basis with respect to certain foreign personal

holding company holdings are restored to the bill (with modifications) and the provisions relating to liquidation of foreign personal holding companies are omitted. Paragraph (1) of subsection (j) redesignates section 1022 of the code as section 1023 and inserts a new section 1022 (relating to increase in basis with respect to certain foreign personal holding company stock or securities).

Section 1014(b)(5) of the code provides that the basis of a share of stock or of a security in a foreign personal holding company, in the hands of a person acquiring it from a decedent by bequest, devise, or inheritance, or acquired by the decedent's estate from the decedent, is the lower of the fair market value of such share or security at the date of the decedent's death or the basis in the hands of the decedent. The new section 1022(a) provides that the basis determined under section 1014(b)(5) of a share of stock or a security, acquired from a decedent dying after December 31, 1963, of a corporation which was a foreign personal holding company for its most recent taxable year ending before the date of the decedent's death is to be increased by such share's or security's proportionate share of any Federal estate tax attributable to the net appreciation in value of all of such shares and securities.

The new section 1022(b) provides that a share's or security's proportionate share of the tax referred to in section 1022(a) is an amount which bears the same ratio to the amount of tax determined under section 1022(c)(2) as the appreciation in value of the share or security bears to the aggregate appreciation in value of all such shares and securities having appreciation in value.

The new section 1022(c) provides special rules and definitions to be used in determining the increase in basis provided in section 1022(a).

Paragraph (1) of section 1022(c) defines the term "Federal estate tax" to mean the tax imposed by section 2001 or 2101 of the code, reduced by any credit allowable with respect to a tax on prior transfers by section 2013 or 2102 of the code.

Paragraph (2) of section 1022(c) provides that the Federal estate tax attributable to the net appreciation in value of all shares of stock and securities to which section 1022(a) applies is the amount which bears the same ratio to the Federal estate tax as the net appreciation in value of all of such shares and securities bears to the value of the gross estate as determined under chapter 11 of the code. If, for estate tax purposes, alternate valuation is elected under section 2032 of the code, the value of the gross estate is to be determined under the provisions of such section.

Paragraph (3) of section 1022(c) provides that the net appreciation in value of all shares and securities to which section 1022(a) applies is the amount by which the fair market value of all shares and securities exceeds the adjusted basis of such property in the hands of the decedent.

Paragraph (4) of section 1022(c) defines "fair market value", for purposes of section 1022, to mean such value determined under chapter 11 of the code. If, for estate tax purposes, alternate valuation is elected under section 2032 of the code, fair market value is to be determined as of the appropriate date provided in such section.

The new section 1022(d) provides that section 1022 is not to apply to any stock or securities of a foreign personal holding company referred to in section 342(a)(2) of the code (relating to foreign corporations which were foreign personal holding companies in 1937).

Paragraph (2) of the new subsection (j) of the bill adds a new paragraph (21) to section 1016(a) of the code providing, in effect, that an increase in basis under section 1022 of the code is to be taken into account in determining the adjusted basis of property to which such provisions apply. Paragraph (3) of the new subsection (j) makes a clerical amendment to the table of sections to part II of subchapter O of chapter 1 of the code.

TREATMENT OF CERTAIN IRON ORE ROYALTIES

Amendments Nos. 151 and 153: The bill as passed by the House amended sections 631(c), 1231(b)(2), and 272 of the code to grant, in the case of certain disposals of iron ore with a retained economic interest, the same treatment which is now available in the case of certain disposals of coal with a retained economic interest. Under such treatment, the gain or loss attributable to such disposals of iron ore is treated as gain or loss from the sale of property used in the trade or business (as defined in sec. 1231(b) of the code).

Under the Senate amendments, this treatment of these disposals of iron ore with a retained economic interest provided by the bill as passed by the House is retained with two exceptions. First, the treatment is to be available only in the case of iron ore mined in the United States. Second, the treatment is not to apply to disposals of iron ore to certain related persons. One of these is where the disposal is to a person whose relationship to the party disposing of the iron ore is such that a loss would be disallowed under section 267 of the code (relating to losses, etc., with respect to transactions between related taxpayers) or section 707(b) (relating to certain sales or exchanges of property with respect to controlled partnerships). The other of these is where the disposal is to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the iron ore.

The House recedes.

INSURANCE COMPANIES

Amendment No. 162:

(*a*) *Certain mutualization distributions made in 1962.*—Subsection (a) of the section added to the bill by this amendment amends section 809(d)(11) of the code (relating to certain mutualization distributions) to allow, as a deduction in the computation of gain from operations, distributions made in 1962, in acquisition of stock, pursuant to a plan of mutualization adopted by a stock life insurance company before January 1, 1958. Existing law permits a deduction for such mutualization distributions made in 1958, 1959, 1960, or 1961.

(*b*) *Accrual of bond discount.*—Subsection (b) of the section added to the bill by Senate amendment No. 162 relates to the accrual of bond discount by insurance companies subject to tax under part I or II of subchapter L of chapter 1 of the code (relating to life insurance companies and certain mutual insurance companies).

Paragraph (1) of this subsection (b) amends section 818(b) of the code (relating to amortization of premium and accrual of discount) to add a new paragraph at the end thereof. The new section 818(b)(3) provides that for taxable years beginning after December 31, 1962,

no accrual of discount shall be required under section 818(b)(1) on any bond (as defined in sec. 171(d) of the code) except in the case of discount which is interest to which section 103 of the code applies or is original issue discount (as defined in sec. 1232(b) of the code). The new section 818(b)(3) also provides that for purposes of section 805(b)(3)(A) of the code, the current earnings rate for any taxable year beginning before January 1, 1963, is to be determined as if the first sentence of the new section 818(b)(3) applied to such taxable year.

Paragraph (2) of subsection (b) of the section added to the bill by Senate amendment No. 162 amends section 822(d)(2) of the code (relating to the amortization of premium and accrual of discount in the case of mutual insurance companies other than life and other than certain fire, flood, and marine insurance companies) by adding a new sentence. This sentence provides that for taxable years beginning after December 31, 1962, no accrual of discount shall be required under section 822(d)(2) of the code on any bond (as defined in sec. 171(d) of the code).

(*c*) *Contributions to qualified pension, etc., plans.*—Subsection (c) of the section added to the bill by Senate amendment No. 162 amends section 832(c)(10) of the code (relating to deductions allowed in computing taxable income of certain insurance companies) to make it clear that in computing the taxable income of insurance companies subject to the tax imposed by section 831 of the code, there shall be allowed the deduction provided in part I of subchapter D of chapter 1 of the code (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.). Under subsection (d) of this section of the bill, this clarification is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

The House recedes on Senate amendment No. 162 with a clerical amendment.

REGULATED INVESTMENT COMPANIES

Amendment No. 163:

(*a*) *Time for mailing certain notices to shareholders.*—Subsection (a) of the section added to the bill by this amendment amends several provisions of part I of subchapter M of chapter 1 of the code (relating to regulated investment companies) to increase from 30 days to 45 days after the close of the regulated investment company's taxable year the time within which such company must mail certain notices to its shareholders. The sections of the code which are amended are sections 852(b)(3)(C), 852(b)(3)(D)(i), 853(c), 854(b)(2), and 855(c). The amendments are to apply to taxable years of regulated investment companies ending on or after the date of the enactment of the bill.

(*b*) *Certain redemptions by unit investment trusts.*—Subsection (b) of the section added to the bill by Senate amendment No. 163 amends section 852 of the code (relating to taxation of regulated investment companies and their shareholders) to add at the end thereof a new subsection (d). Under section 852(b) of existing law, a regulated investment company is allowed a deduction for dividends paid (as defined in sec. 561), other than capital gains dividends, in determining its investment company taxable income, and is allowed a deduction for dividends paid (as defined in sec. 561), determined with reference to capital gains dividends only, in computing that part of the excess

of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax. Section 562(c) of the code (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled to such preference.

The new section 852(d) added to the code by this amendment provides that in the case of a unit investment trust—

(1) which is registered under the Investment Company Act of 1940 and issues periodic payment plan certificates (as defined in such act); and

(2) substantially all of the assets of which consist of securities issued by a management company (as defined in such act);

section 562(c) of the code (relating to preferential dividends) shall not apply to a distribution by such trust to a holder of an interest in such trust in redemption of part or all of such interest, with respect to the net capital gain of such trust attributable to such redemption. The effect of this change is that, where the requirements of the new section 852(d) are met, the distribution is considered to be a distribution by the trust which qualifies for the deduction for dividends paid with respect to capital gains dividends under section 852(b)(3)(A) of the code. This change is to apply to taxable years of regulated investment companies ending after December 31, 1963.

The House recedes on Senate amendment No. 163 with a clerical amendment.

FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN FOREIGN MINERAL INCOME

Amendment No. 164: This amendment inserts a new subsection (d) in section 901 of the code (relating to credit for foreign taxes). Paragraph (1) of the new subsection (d) provides that in certain cases the amount of foreign taxes described in section 901 (relating to amount of foreign tax allowed as a credit) which are paid or accrued during the taxable year with respect to mineral income to any foreign country (if the per-country limitation applies), or to all foreign countries (if the overall limitation applies), is to be reduced for purposes of computing the foreign tax credit.

The Senate recedes.

AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

Amendment No. 165: This amendment adds a new section 1003 to part I of subchapter 0 of chapter 1 of the code (relating to determination of amount of and recognition of gain or loss). Subsection (a) of the new section 1003 provides that if property used by the taxpayer as his principal residence is sold by the taxpayer or his spouse pursuant to a sales contract entered into within the forced sale period for such property, and if the taxpayer's employer, not later than 1 year after the date such sales contract was entered into, pays part or all of the sale differential on such property, then for

purposes of chapter 1 of the code the amount so paid is to be treated by the taxpayer or his spouse as an additional amount realized on the sale of such property to the extent that it does not exceed the lesser of (1) the sale differential, or (2) 15 percent of the gross sales price of such property.

Subsection (b) of the new section 1003 places certain limitations on the application of such section. Subsection (c) contains definitions and special rules for the application of the new section.

The new section 1003 is to apply to amounts paid with respect to sales contracts entered into after December 31, 1963, in taxable years ending after such date.

The Senate recedes.

CAPITAL GAINS AND LOSSES

Amendment No. 166: Section 219(a) of the bill as passed by the House amended the code to provide, in the case of taxpayers other than corporations, for the splitting of the long-term capital gain or loss category into two categories: (1) Class B capital gain or loss (in general, gain or loss from the sale or exchange of a capital asset held for more than 6 months but not more than 2 years); and (2) class A capital gain or loss (in general, gain or loss from the sale or exchange of a capital asset held for more than 2 years). Under the bill as passed by the House the deduction under section 1202 of the code for an excess of net long-term capital gain over net short-term capital loss was increased, in the case of adjusted class A capital gain (as defined in the bill), from 50 percent to 60 percent. It also provided that the alternative maximum capital gain tax provided by section 1201(b) of the code for taxpayers other than corporations was to be decreased, in the case of adjusted class A capital gain, from 25 percent to 21 percent.

Under existing section 1212 of the code, if a taxpayer has a net capital loss for a taxable year, the amount thereof is a short-term capital loss in each of the 5 succeeding taxable years, to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. Section 219(b) of the House bill in effect provided, in the case of a taxpayer other than a corporation, for an unlimited carryover of a net short-term, net class B, or net class A capital loss.

Senate amendment No. 166 strikes out this section of the bill as passed by the House.

Under the conference agreement, the House recedes with an amendment which adds a new subsection (b) to section 1212 of the code and makes technical changes in the definitions contained in paragraphs (9) and (10) of section 1222 of the code (relating to terms relating to capital gains and losses). Under paragraph (1) of the new subsection (b), in the case of a taxpayer other than a corporation, the excess of the net short-term capital loss over the net long-term capital gain for a taxable year, and the excess of the net long-term capital loss over the net short-term capital gain for such year are to be treated, respectively, as a short-term and a long-term capital loss in the succeeding taxable year. In determining a net short-term capital gain or loss of a taxable year, for purposes of computing a capital loss carryover to the succeeding taxable year, an amount equal to the excess of the capital losses allowable as a deduction for the taxable year by virtue of section 1211(b) of the code (relating to limitation on capital

losses) over the capital gains for such year is treated as a short-term capital gain occurring in such year. The effect of the latter rule is to reduce first the amount of a net short-term capital loss which may be carried over to a succeeding taxable year by the amount of capital losses which were allowed against ordinary income in the loss year and then to reduce the amount of a net long-term capital loss which may be carried over to the succeeding taxable year by any balance of the capital losses allowed against ordinary income in the loss year.

Paragraph (2) of new subsection (b) contains a transitional rule. The transitional rule provides, in effect, that, in the case of a taxpayer other than a corporation, any capital loss carryover which, under subchapter P of chapter 1 of the code as in effect immediately before the enactment of the bill is treated as a short-term capital loss in the first taxable year of a taxpayer beginning after December 31, 1963, is to be treated as a short-term capital loss in such year irrespective of the fact that such carryover may be composed in whole or in part of losses which were long-term capital losses in the year in which sustained.

Under the conference agreement, the amendments of sections 1212 and 1222 of the code are to apply to taxable years beginning after December 31, 1963.

ELECTION OF STANDARD DEDUCTION BY CERTAIN INDIVIDUALS WHO ELECT TO AVERAGE INCOME

Amendment No. 171: This amendment amends section 144 of the code (relating to election of standard deduction) to allow an individual who chooses the benefits of income averaging and whose adjusted gross income for the computation year is less than $5,000 to elect the standard deduction.

The House recedes.

SMALL BUSINESS CORPORATIONS

Amendment No. 177: This amendment amends section 1371 of the code (defining "small business corporation" for purposes of subch. S of ch. 1 of the code, relating to election as to taxable status) by adding at the end thereof a new subsection (d) and amends section 1375 of the code (relating to special rules applicable to distributions of electing small business corporations) by adding at the end thereof a new subsection (e).

Under existing section 1371(a) of the code the definition of a "small business corporation" does not include any corporation which is a member of an affiliated group (as defined in sec. 1504 of the code). The new subsection (d) added to section 1371 of the code by Senate amendment No. 177 provides that, for purposes of section 1371(a), a corporation is not to be considered a member of an affiliated group at any time during the taxable year by reason of ownership of stock in another corporation if such other corporation has not begun business at any time on or after the date of its incorporation and before the close of such taxable year and if such other corporation does not have taxable income for the period included within such taxable year. The new subsection (d) is to apply to taxable years of corporations beginning after December 31, 1962.

The new subsection (e) added to section 1375 provides that under specified circumstances a distribution of money made by a corporation

on or before the 15th day of the 3d month following a taxable year for which such corporation is an electing small business corporation shall be treated for purposes of chapter 1 of the code as made on the last day of such taxable year. The new subsection (e) is to apply to taxable years beginning after December 31, 1957.

The House recedes with a clerical amendment.

VALIDITY OF TAX LIENS AGAINST PURCHASERS OF MOTOR VEHICLES

Amendment No. 193: Section 6323(a) of the code provides that the lien for taxes provided by section 6321 of the code is not to be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary of the Treasury or his delegate in the appropriate office specified in section 6323(a). Senate amendment No. 193 amends section 6323(c) of the code which contains a special rule as to the validity of tax liens in the case of securities to make that special rule applicable also with respect to motor vehicles. Under the Senate amendment, even though notice of lien has been filed in the manner prescribed in section 6323(a) of the code, the lien is not to be valid with respect to a motor vehicle as against any mortgagee, pledgee, or purchaser of such motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien.

Senate amendment No. 193 also amends section 6324 of the code (relating to special liens for estate and gift taxes) to grant, in the case of the mortgage, pledge, or purchase of a motor vehicle, the same treatment which is now available in the case of the mortgage, pledge, or purchase of a security after a lien for estate or gift tax has arisen. Under the amendment, even though a special lien for estate or gift tax has arisen, such lien will not be valid with respect to any mortgagee, pledgee, or purchaser of a motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase, such mortgagee, pledgee, or purchaser was without notice or knowledge of the existence of such lien.

Under the amendment, these changes to sections 6323 and 6324 of the code apply to mortgages, pledges, and purchases made after the date of the enactment of the bill.

The House recedes with an amendment. Section 6323 (relating to validity of tax liens against mortgagees, pledgees, purchasers, and judgment creditors) is amended by redesignating subsection (d) as subsection (e) and by inserting a new subsection (d) which provides that even though notice of lien imposed by section 6321 has been properly filed, the lien shall not be valid with respect to a motor vehicle as against a purchaser thereof for an adequate and full consideration in money or money's worth if (1) at the time of the purchase, the purchaser is without notice or knowledge of the existence of such lien, and (2) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

Section 6324 (relating to special liens for estate and gift taxes) is amended by adding a new subsection (d) which provides in effect that a lien for estate or gift taxes will be invalid as against a purchaser of a motor vehicle (as defined in sec. 6323 (d)(2)) for an adequate and full

consideration in money or money's worth if (1) at the time of the purchase, such purchaser is without notice or knowledge of such lien, and (2) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

Where a motor vehicle is purchased under the circumstances specified in the new section 6323(d) or 6324(d) of the code, the tax lien will abate with respect to the motor vehicle in question and will not be valid against any subsequent purchaser (or other successor in interest) of the vehicle.

The amendments to sections 6323 and 6324 of the code apply to purchases made after the date of the enactment of the bill.

EXCLUSION OF EARNED INCOME OF CERTAIN U.S. CITIZENS WHO ARE RESIDENTS OF FOREIGN COUNTRIES

Amendment No. 194: This amendment adds a new section to the bill amending section 911(c)(1) of the code (relating to limitations on amount of exclusion of earned income from sources without the United States). Existing section 911(c)(1) provides in effect that the amount excluded from the gross income of an individual under section 911(a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of—

(A) except as provided in subparagraph (B), $20,000 in the case of an individual who qualifies under section 911(a); or

(B) $35,000 in the case of an individual who qualifies under section 911(a)(1) (relating to bona fide resident of foreign country), but only with respect to that portion of the taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

Senate amendment No. 194 amends section 911(c)(1)(A) to substitute "$4,000" for the $20,000 amount contained therein, and it amends section 911(c)(1)(B) to substitute "$6,000" for the $35,000 amount contained therein. Under the amendment these changes are applicable only with respect to taxable years beginning after December 31, 1963.

The House recedes with an amendment. Under the conference agreement, the limitation contained in subparagraph (B) of section 911(c)(1) of the code (relating to limitations on amount of exclusion of earned income from sources without the United States) is reduced from $35,000 to $25,000, effective for taxable years beginning after December 31, 1964.

DEFINITION OF HEAD OF HOUSEHOLD

Amendment No. 195: Section 1(b)(2) of the code defines a head of a household to be an individual who is not married at the close of his taxable year, is not a surviving spouse, and maintains a household which constitutes for the taxable year the principal place of abode of a dependent for whom the taxpayer is entitled to a deduction for the taxable year under section 151 of the code or (if not married at the close of the taxpayer's taxable year) a child, stepchild, or descendant. Except in the case of a father or mother, the household must be maintained as the home of the taxpayer. The effect of Senate amendment No. 195 is to remove the requirement that the household be maintained

as the home of the taxpayer and to provide that a taxpayer may qualify as a head of household with respect to a child, stepchild, or descendant only if he is a dependent for whom the taxpayer is entitled to a deduction for the taxable year.

The Senate recedes.

LOSSES ARISING FROM CONFISCATION OF PROPERTY BY CUBA

Amendment No. 196: Section 165(c)(3) of the code provides that, in the case of an individual, the deduction for losses provided by section 165(a) shall, except for losses incurred in a trade or business or in a transaction entered into for profit, be limited to losses of property arising from fire, storm, shipwreck, or other casualty, or from theft. Section 172(d)(4) of the code provides for purposes of the net operating loss that, in the case of a taxpayer other than a corporation, the deductions not attributable to a taxpayer's trade or business shall be allowed only to the extent of the gross income not derived from such trade or business. This limitation does not apply to a deduction allowable under section 165(c)(3) of the code.

Senate amendment No. 196 adds a new subsection (i) to section 165 of the code which provides that, for purposes of section 165(c)(3), losses of property which arise from expropriation, intervention in, or confiscation by Cuba shall be deemed to be losses from "other casualty."

The House recedes with an amendment which limits the application of the new section 165(i) to losses of tangible property and which makes technical and conforming changes.

CREDIT OR REFUND OF SELF-EMPLOYMENT TAX

Amendment No. 197: This amendment adds a new provision to the code to permit credit or refund of self-employment tax if, by reason of an agreement made pursuant to section 218 of the Social Security Act, the self-employment income of an individual (for a year with respect to which the period of limitation for filing claim for credit or refund has expired) is different from what it would be but for the agreement.

The House recedes with an amendment. Under the conference agreement, a new paragraph (5) is added to 6511(d) of the code The new paragraph (5) applies both to agreements and modifications of agreements under section 218 of the Social Security Act. The new paragraph (5) also provides that if the allowance of a credit or refund of an overpayment attributable to such an agreement or modification is otherwise prevented by the operation of any law or rule of law other than section 7122 of the code (relating to compromises) such credit or refund may be allowed or made if claim therefor is filed on or before whichever of the following is the later: (A) the last day of the second year after the calendar year in which such agreement or modification is agreed to by the State and the Secretary of Health, Education, and Welfare, or (B) December 31, 1965.

EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX ON VALUE OF REVERSIONARY OR REMAINDER INTEREST IN PROPERTY

Amendment No. 198: Section 6163(a) of the 1954 code provides that if the value of a reversionary or remainder interest in property is

included in the value of the gross estate for purposes of the estate tax, then the payment of the part of the estate tax attributable to the interest may (at the election of the executor) be postponed until 6 months after the termination of the precedent interest or interests in the property. A similar rule applies under the 1939 code. Under section 6163(b) of the 1954 code (or sec. 925 of the 1939 code), if the Secretary of the Treasury or his delegate finds that the payment of the tax at the expiration of the period of postponement would result in undue hardship to the estate, he may extend the time for payment for a reasonable period not in excess of 2 years from such period of postponement. Under Senate amendment No. 198, he would be permitted to extend the time for payment for a reasonable period or periods not in excess of 3 years from the expiration of such period of postponement.

The House recedes with clerical amendments.

CROP INSURANCE PROCEEDS

Amendment No. 199: This amendment adds a new subsection (c) to section 451 of the code (relating to general rule for taxable year of including items in gross income). Under the new subsection, in the case of insurance proceeds received as a result of destruction or damage to crops, a taxpayer reporting on the cash basis of accounting may elect to include such proceeds in income for the year following the year of destruction or damage provided he establishes to the satisfaction of the Secretary of the Treasury or his delegate that, under his practice, income from such crops would not have been reported in the year in which raised.

The Senate recedes.

TRANSPORTATION OF DISABLED INDIVIDUAL TO AND FROM WORK

Amendment No. 200: This amendment adds a new section 219 to the code. Section 219(a) provides that in the case of a disabled individual there shall be allowed as a deduction expenses paid during the taxable year for transportation to and from work to the extent that such expenses do not exceed $600. Section 219(b) defines the term "disabled individual" and contains rules as to the submission of proof and certification of disability.

The Senate recedes.

ADDITIONAL PERSONAL EXEMPTIONS FOR DISABILITY

Amendment No. 201: This amendment adds a new subsection (f) to section 151 of the code (relating to allowance of deductions for personal exemptions). The new subsection (f) provides an additional exemption of $600 for the taxpayer if he is a disabled individual (as defined in new subsec. (f)(3)) and an additional exemption of $600 for the spouse if the spouse is a disabled individual (as so defined) and if the taxpayer is entitled to an exemption under section 151(b) of the code for such spouse.

The Senate recedes.

TIME FOR FILING CLAIM FOR REFUND OF TAXES PAID FOR GASOLINE USED ON FARMS

Amendment No. 202: The second sentence of section 6420(b) of the code provides that no claim shall be allowed under section 6420

of the code (relating to payments to ultimate purchaser of amounts equivalent to tax on gasoline used on a farm for farming purposes) with respect to any 1-year period (ending on June 30) unless filed on or before September 30 of the year in which such 1-year period ends. The effect of Senate amendment No. 202 is to permit the Secretary of the Treasury or his delegate to allow a claim filed after September 30 if the claimant had good cause for failing to file on or before such date.

The Senate recedes.

FACILITIES TO CONTROL WATER OR AIR POLLUTION

Amendment No. 203: Section 46(a) of the code provides, in general, that the credit against income tax allowed by section 38 (relating to investment in certain depreciable property) shall be equal to 7 percent of the qualified investment (as defined in sec. 46(c)). Under section 46(c)(1), the qualified investment with respect to any taxable year is the aggregate of the applicable percentage of the basis of each new section 38 property (or of the cost of each used sec. 38 property) placed in service by the taxpayer during the taxable year. The applicable percentage (33⅓, 66⅔, or 100 percent) is determined by reference to the useful life of the property. Senate amendment No. 203 adds a new paragraph (5) to section 46(c). Under the new paragraph, in the case of section 38 property which consists of facilities or equipment to control water or air pollution, the amount of the qualified investment shall be twice the amount determined under section 46(c)(1).

The Senate recedes.

INCOME TAX COLLECTED AT SOURCE

Amendments Nos. 204, 205, 206, 207, and 208: Section 302 of the bill as passed by the House provided a 15-percent withholding rate for wages paid during calendar year 1964 and a 14-percent withholding rate for wages paid after December 31, 1964. The bill as passed by the House also provided that the withholding rate on certain payments to nonresident aliens was to be 15 percent in the case of such payments made during calendar year 1964 and 14 percent in the case of such payments made after December 31, 1964.

Under the Senate amendments the withholding rate for wages and for the payments to nonresident aliens described in the preceding paragraph is 14 percent, effective with respect to wages paid (and such payments made) after the seventh day after the date on which the bill is enacted.

The House recedes.

W. D. Mills,
Cecil R. King,
Thos. J. O'Brien,
Hale Boggs,
John W. Byrnes,
Victor A. Knox,
Managers on the Part of the House.

[H.R. 8363][1]

REVENUE ACT OF 1964

[Brief Summary of the Provisions as Agreed to by the Conferees, Eighty-eighth Congress, Second Session]

[February 28, 1964]

(1) *Section 1: Declaration by Congress.*—It is the sense of Congress that the tax reduction provided by this bill, through stimulation of the economy, after a brief transitional period will raise (rather than lower) revenues and that these revenues should first be used to eliminate deficits and then the public debt. Congress also recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to do the same.

(2) *Section 2:* The title of the bill is the Revenue Act of 1964.

(3) *Section 111: Individual rates.*—This reduces the rates of tax for individuals from a range of 20 to 91 percent to a range of 16 to 77 percent for 1964 and to a range of 14 to 70 percent for 1965 and subsequent years. This also splits the first bracket into four segments of $500 each, taxed at 14, 15, 16, and 17 percent, respectively.

(4) *Section 112: Minimum standard deduction.*—This provides that, if higher than the 10-percent standard deduction, the "minimum standard deduction" is to be $200 plus $100 for each exemption (or $300 for the first exemption and $100 for each additional exemption). Thus, the exemption and minimum standard deduction for a single person will be $900; for a married couple, $1,600; and, for a married couple with two children, $3,000.

(5) *Section 113: Related amendments.*—This conforms the tax rate applicable to the retirement income credit with the new rate schedules. Thus, it makes the rate applicable to the retirement income 17 percent for 1964 and 15 percent for subsequent years (instead of 20 percent). This also conforms the floor on the tax on nonresident aliens with the new rate schedule by raising from $15,400 to $19,000 in 1964 and to $21,200 in 1965 and subsequent years the income level to which the regular, rather than the flat 30-percent rate, may be applicable.

(6) *Section 114.*—This is a cross-reference.

(7) *Section 121: Corporate rates.*—This reduces the overall corporate tax rate from the present 52 percent to 50 percent in 1964 and 48 percent in subsequent years. It also reduces the rate applicable to the first $25,000 of corporate income, from the present 30 percent, to 22 percent for 1964 and subsequent years.

(8) *Section 122: Acceleration of corporate tax.*—This section provides for a speedup in the payment of corporate taxes. It applies only to tax liability in excess of $100,000. At present, 50 percent of tax liability over $100,000 is payable in two installments in September and December (for a calendar year corporation) in the current year of liability. This accelerates the other two payments now made after the end of the year with respect to this liability over $100,000 so that by 1970 these two 25-percent payments also will be made in the current year of liability in April and June (for a calendar year corpo-

[1] Public Law 88-272, page 6, this Bulletin.

ration). This speedup is provided on a gradual basis. Thus, 1 percent of this liability in April and 1 percent in June will be reported for 1964, 4 percent for each of these two months in 1965, 9 percent for 1966, 14 percent for 1967, 19 percent for 1968, 22 percent for 1969, and the full 25 percent for 1970.

(9) *Section 123: Related amendments.*—This conforms other provisions in the Internal Revenue Code to the changes made with respect to corporate rates in section 121. The conforming amendments relate to the tax on mutual insurance companies (other than life) and receipts of minimum distributions for domestic corporations from their foreign subsidiaries.

(10) *Section 131: Effective date.*—This provides that the corporate and individual rate changes are to be effective generally for taxable years beginning after December 31, 1963.

(11) *Section 132: Fiscal year taxpayers.*—This provides that the individual and corporate rate changes for fiscal year taxpayers are to apply to that portion of their years ending after December 31, 1963.

(12) *Section 201: Dividend credit and exclusion.*—The 4-percent dividends received credit available to individuals is reduced to 2 percent for 1964 and repealed for subsequent years. The $50 dividend exclusion is increased to $100 for 1964 and subsequent years. This increase is from $100 to $200 for married couples where each spouse has sufficient dividend income or the two do jointly.

(13) *Section 202: Retirement income credit.*—This provides that a couple, both over 65, making a joint return may, at their election, have a total retirement income credit of $2,286 applicable to the retirement income of either or both if either spouse meets the 10-year earned income requirement. The $2,286 amount is required to be reduced by amounts received as tax-exempt pensions and annuities and by amounts representing adjustments for earned income. (These are the reductions applying to the $1,524 ceiling under present law.)

(14) *Section 203: Investment credit.*—In the case of the investment credit, the provision requiring a downward adjustment in the basis of property eligible for depreciation, to the extent of the 7-percent investment credit, is repealed. Also Federal regulatory commissions are prohibited from requiring the "flowthrough" of any of the benefits of the investment credit to the customers of the regulated industries in the case of property eligible for the full 7-percent credit (mainly the transportation industries such as railroads, airlines, and pipelines). In the case of public utilities eligible only for the 3-percent credit (principally telephone and electric companies), the regulatory commissions are not to require the "flowthrough" of the benefits of the investment credit in any period of time shorter than the usual life of the asset involved. Other changes make the investment credit available in the case of elevators and escalators and increase the base on which the credit of the lessee is to be computed where dealers lease property eligible for the credit.

(15) *Section 204: Group term insurance.*—The employee exclusion for premiums on group term insurance furnished through the employer is limited to premiums paid on the first $50,000 of coverage, and information reporting requirements are provided for those employees receiving more than $50,000 of such insurance.

(16) *Section 205: Sick pay exclusion.*—Sick pay received after the taxpayer has been absent from work more than 30 days is to be

excluded from income up to $100 a week. Within the 30-day period if the sick pay is 75 percent or less of the regular weekly rate, then up to $75 a week may be excluded after an absence of 7 calendar days on account of injuries or illness, and from the first day without any waiting period, if the taxpayer is hospitalized at least 1 day in the first 7.

(17) *Section 206: Sale of residence.*—An exclusion from taxable income is provided for any capital gain attributable to the first $20,000 of the sale price of a personal residence in the case of an individual age 65 or over who owned the house for 8 years and occupied it for 5 of them.

(18) *Section 207: State and local taxes.*—A deduction is denied in computing income subject to Federal tax for State and local taxes other than property taxes, income taxes, general sales taxes, and gasoline taxes. The principal taxes for which this denies a deduction are alcoholic beverage taxes, cigarette taxes, auto registration fees and licenses, and selective excise taxes.

(19) *Section 208: Casualty losses.*—The deduction for personal casualty and theft losses is limited to the amount in excess of $100 per loss, in a manner somewhat similar to the treatment of "$100 deductible" insurance.

(20) *Section 209: Charitable contributions.*—The following changes are made in the charitable contribution deduction:

(*a*) The additional 10-percent maximum deduction (above the 20 percent generally available) is made available generally for contributions to publicly supported organizations other than private foundations (presently it is available chiefly for churches, schools, and hospitals);

(*b*) The unlimited charitable contribution deduction is restricted to contributions to churches, schools, hospitals, and other publicly supported organizations and to a privately supported organization if (i) the organization is an operating charity or (ii) expends 50 percent of the contribution within 3 years after the year it was received (as well as all its net income during the period); in addition for a contribution to a privately supported organization to be deductible under this provision, the person making the contribution must not engage in certain disqualifying transactions with such organization;

(*c*) A 5-year carryover of charitable contributions (in excess of the amount currently deductible) is provided for individuals with respect to contributions to publicly supported organizations;

(*d*) The 2-year carryover of charitable contribution deductions for corporations is extended to 5 years (this is available for contributions made in 1962 and 1963 as well as subsequent years);

(*e*) Charitable contribution deductions for gifts of future interest made after June 30, 1964, in tangible personal property are denied until the gifts are completed.

(21) *Section 210: Expropriation losses.*—Businesses which have sustained substantial "foreign expropriation losses" after 1958 are permitted to carry such losses forward and apply them against income for a 10-year period. This is in place of the regular 3-year carryback and 5-year carryforward which will still remain available or other net operating losses.

(22) *Section 211: Medicines and drugs.*—The 1-percent limitation, or floor, on medicines and drugs, which must be taken into account in determining deductible medical expenses, is made inapplicable where the taxpayer or his wife is over 65 and also with respect to expenses for dependent parents over 65. This conforms the treatment with respect to the 1-percent limitation with that provided in the case of the 3-percent limitation for medical expenses generally.

(23) *Section 212: Child care.*—The child care deduction is revised—

(*a*) To make it available in the case of a husband whose wife is incapacitated or institutionalized;

(*b*) To make it available with respect to care for children up to age 13 (instead of 12);

(*c*) The maximum deduction allowable where there are two or more children is increased from $600 to $900; and

(*d*) The present limitation on family income in the case of a working wife eligible for this deduction is raised from $4,500 to $6,000 and is also made applicable in respect of husbands with incapacitated wives.

(24) *Section 213: Moving expenses.*—A deduction is allowed for certain moving expenses—transportation of household goods, transportation of the persons involved, and meals and lodging of the persons while in transit—for employees who are not reimbursed for these expenses and also for new employees. An exclusion of these items is already available in the case of old employees who are reimbursed.

(25) *Section 214: 100-percent dividend deduction.*—Affiliated groups of corporations, where there is an 80-percent common ownership, which are eligible to file a consolidated return but do not do so, are permitted to take a 100-percent deduction for intercorporate dividends received from other members of the group if the group agrees to be treated as a single entity for certain purposes, such as the $25,000 surtax exemption determining what proportion of its taxes must be paid currently, etc.

(26) *Section 215: Bank loan insurance.*—An interest deduction is denied for amounts borrowed under a systematic plan to pay premiums on life insurance under policies purchased after August 6, 1963. The deduction is denied only if part or all of four of the first seven annual premiums are borrowed, the interest exceeds $100 a year, the amounts borrowed were not unforeseen emergencies, or the amounts borrowed were not incurred in connection with a business.

(27) *Section 216: Face-amount certificate companies.*—Financial institutions subject to State banking laws and issuing face-amount certificates are not in any event to be denied a deduction for interest paid on these certificates under section 265(2) of the code (relating to interest indebtedness to carry tax-exempt obligations) to the extent the tax-exempt obligations do not constitute more than 15 percent of the average of the institutions' total assets.

(28) *Section 217: Travel expenses.*—The rule adopted in 1962 which disallows a portion of travel expenses for certain business trips combined with a vacation is modified to apply only in the case of travel outside the United States.

(29) *Section 218: Reorganizations.*—Tax-free status is provided for a stock-for-stock reorganization where the corporation acquiring the stock exchanges the voting stock of its parent corporation for the stock of the corporation being acquired.

(30) *Section 219: Multiemployer pension plans.*—Provision is made for the retroactive qualification of a pension plan under a multiemployer agreement with unions where the pension plan subsequently becomes qualified.

(31) *Section 220: Pension coverage of employees abroad.*—U.S. corporations are to be permitted to extend coverage under their qualified pension, profit sharing, et cetera, plans to U.S. citizens employed by foreign subsidiaries or by domestic subsidiaries operating outside the United States. Generally, this treatment will not be available in the case of foreign subsidiaries unless their employees are also covered for social security purposes.

(32) *Section 221: Stock options.*—The present tax treatment of employee stock options is further restricted, the principal additional restrictions being—

(*a*) The stock when acquired must be held for 3 years or more;

(*b*) The options must not be for a period of more than 5 years;

(*c*) The option price must at least equal the market price of the stock when the option is granted;

(*d*) Stockholders' approval of the options must be obtained; and

(*e*) The extent to which new options may be exercised when old options are outstanding is restricted.

Separate tax treatment is provided for employee stock purchase plans which are available to all employees on a nondiscriminatory basis under rules which are substantially the same as under present law.

(33) *Section 222: Revolving credit.*—Installment sales treatment, under which the income is reported as the installment is received, is extended to revolving credit sales with respect to accounts not used as ordinary charge accounts.

(34) *Section 223: Contested items.*—Where a taxpayer contests a tax or other liability, he is, nevertheless, to be permitted a deduction for the item in the year in which he makes the payment if this is earlier than the year in which the contest is settled.

(35) *Section 224: Unstated interest.*—Where property is sold on an installment basis and either no, or very little, interest is charged on the installments, an appropriate amount of each installment is to be treated as if it were an interest payment. This section also provides that the interest element in certain installment payments for educational services (including lodging) may be treated as deductible interest.

(36) *Section 225: Personal holding companies.*—The percentage of passive income which may result in a company being classified as a personal holding company is reduced from 80 to 60 percent and amendments are made so that the personal holding company tax cannot be avoided by using rental income or oil or gas or mineral royalties (or working interests) to shelter substantial amounts of investment income, such as dividends and interest, from the personal holding company tax. Other restrictive amendments are also made. In addition, relief is provided for those companies which are not now personal holding companies, but would be under the new definitions. They are permitted favorable liquidation treatment in certain cases and also permitted a deduction in computing the personal holding company income for paying off existing debts. The section also provides that the basis of foreign personal holding company stock trans-

mitted at death is to be increased by the Federal estate tax attributable to appreciation in such stock.

(37) *Section 226: Aggregations of property.*—For the future, oil and gas leases and acquisitions may no longer be aggregated into "operating units" in determining what constitutes a property for purposes of computing the 50-percent net income limitation in the case of the percentage depletion deduction.

(38) *Section 227: Iron ore royalties.*—Capital gains treatment is extended to iron ore royalties where the iron ore is mined in the United States and the persons acquiring the ore are not related to the persons owning the property.

(39) *Section 228: Insurance companies.*—Three changes are made with respect to the income tax of insurance companies:

> (*a*) The present rule providing for the deduction of certain distributions in 1958 through 1961 to shareholders pursuant to "mutualizations" of stock life insurance companies are extended to cover distributions in 1962;
>
> (*b*) The requirement of present law that life insurance companies, and small mutual casualty insurance companies taxed on investment income only, are to ratably accrue market discount on purchased bonds as ordinary income is removed with the result that this will be treated as capital gains; and
>
> (*c*) A change is made to assure the deductibility of qualified pension plan contributions of stock casualty insurance companies.

(40) *Section 229: Mutual funds.*—Regulated investment companies (i.e., mutual funds meeting certain requirements) are to be given 45 days after the close of their taxable year rather than 30 days to give notices to their shareholders as to the treatment by the shareholders of income received from the companies. In addition, a provision is added to the effect that distributions by a unit investment trust liquidating an individual's interests in the trust are not to be considered as giving rise to capital gains tax with respect to interests of other investors still in the trust.

(41) *Section 230: Capital loss carryovers.*—Individuals will have an unlimited carryover of capital losses. (Instead of the 5-year carryover of present law). However, these losses are to retain their character as short-term or long-term losses (rather than always being treated as short-term losses in the year to which they are carried).)

(42) *Section 231: Gains on real estate.*—In the case of real estate sold in the future, any depreciation deduction, to the extent the deductions exceed the depreciation which would have been allowable under the straight line method (but only to the extent of any gain), are to be treated as giving rise to ordinary income. However, in the case of property held more than 20 months, the amount treated as ordinary income is to be reduced by 1 percent for each month of holding over 20, with the result that these amounts are taxed as capital gains, rather than as ordinary income, in the case of real property held more than 10 years.

(43) *Section 232: Averaging.*—In place of the various specialized averaging provisions available under present law, what in effect amounts to averaging of income over a 5-year period is to be available for the income in the current year which exceeds the average of the income of the 4 prior years by more than one-third but only if the excess over this 1⅓ amounts to more than $3,000.

(44) *Section 233: Subchapter S corporations.*—In the case of subchapter S corporations, the income of which is treated essentially like partnership income, it is provided that certain distributions of money after the close of a taxable year may be treated as made during the year, in order to prevent the double inclusion of this income in the tax base of a shareholder; and that a corporation member of an affiliated group may elect subchapter S treatment if the only other members of the group are inactive subsidiary corporations.

(45) *Section 234: Consolidated returns.*—The 2-percent penalty tax which presently must be paid by corporations for the privilege of filing consolidated returns is repealed.

(46) *Section 235: Multiple surtax exemptions.*—For corporations where there is common control to the extent of 80 percent or more, the corporations involved may, as under present law, file a consolidated return (except in the case of brother-sister affiliations), or may claim one $25,000 surtax exemption for the group, or alternatively may continue to each claim their own surtax exemption if a special tax of 6 percent is paid upon the first $25,000 of the income of each of these corporations. In addition, under present law, corporations may not transfer directly all or part of their property (other than money) to another corporation if the other corporation was created for the purpose of acquiring the property and was not actively engaged in business at the time of the acquisition and still have each of these corporations eligible for its own surtax exemption. This treatment is extended to cover cases where the same result is obtained indirectly as well as directly and also where the result is obtained where five or fewer individuals who control a corporation transfer property directly or indirectly to a transferee corporation.

(47) *Section 236: Tax liens.*—A purchaser (but not a mortgagee or pledgee) of a motor vehicle who acquires possession will not be subject to a Federal tax lien against the motor vehicle, notice of which has been publicly filed unless he has actual knowledge of the existence of the lien.

(48) *Section 237: Earned income of U.S. citizens abroad.*—In the case of U.S. citizens who are present in a foreign country for 17 out of 18 consecutive months, or who are bona fide residents of a foreign country for not more than 3 years, the limitation on the exclusion from gross income is continued at $20,000; but in the case of a U.S. citizen who is a bona fide resident of a foreign country for more than 3 years the exclusion is to be $25,000 after 1964 (instead of $35,000).

(49) *Section 238: Cuban seizures of nonbusiness property.*—A deduction for losses occasioned by the seizure, by Cuba, of personal residences (and other tangible nonbusiness property) is made available prospectively by treating such losses as losses arising from a casualty.

(50) *Section 239: Refund of self-employment tax.*—This permits persons who paid self-employment tax and who are later covered for the same period by a retroactive social security agreement entered into by a State to obtain a refund of the self-employment tax. Employees may already obtain a refund of the social security taxes paid by them in this situation.

(51) *Section 240: Estate tax on reversionary or remainder interest.*—This provides 3 years (rather than 2) after a precedent interest terminates for the payment of estate tax with respect to reversionary or remainder interests if earlier payment results in undue hardship.

(52) *Section 301: Optional tax tables.*—Optional tax tables are provided for those with adjusted gross income of less than $5,000 for the year 1964 and for 1965 and for subsequent years. These tables reflect the rate reductions for individuals referred to in section 111 above.

(53) *Section 302: Withholding.*—Provision is made for a withholding rate of 14 percent in lieu of the 18 percent applicable under present law. This is to apply to payments made after the seventh day following the date of enactment of this bill. Withholding rate tables to reflect this 14-percent withholding rate are also provided.

[S. 2394] [1]

COMPLIANCE WITH CONVENTION ON THE CHAMIZAL

[Senate Report No. 868, Eighty-eighth Congress, Second Session, Calendar No. 845]

[February 5 (legislative day, February 4), 1963]

MR. FULBRIGHT, from the Committee on Foreign Relations, submitted the following report to accompany S. 2394.

The Committee on Foreign Relations, having had under consideration S.2394, a bill to facilitate compliance with the convention between the United States of America and the United Mexican States, signed August 29, 1963, and for other purposes, reports the bill favorably to the Senate, with amendments, and recommends that it pass as amended.

I. BACKGROUND

The Convention on the Chamizal was approved by the Senate on December 17, 1963, by a vote of 79 to 1. The objective of the convention was to settle a long-standing boundary dispute between the United States and Mexico concerning the Chamizal, an area of land situated to the north of the Rio Grande, in the El Paso, Tex.-Cuidad Juárez, Mexico region. The treaty entered into force on January 14, 1964.

A letter from the Secretary of State with draft legislation to implement the convention was transmitted to the Senate on December 16, 1963, and the draft legislation was introduced as S. 2394 by Senator Sparkman, by request, the following day.

II. MAIN PURPOSE OF S. 2394

The principal objective of S. 2394 is to implement the Convention on the Chamizal by authorizing appropriations to enable the acquisition of lands to be transferred to Mexico and to make possible the relocation of the channel of the Rio Grande and other required relocations. The bill would also authorize special compensation to avoid economic injury to property owners and tenants affected by the Chamizal settlement and would provide for the relocation and expansion of port-of-entry facilities.

III. COSTS INVOLVED IN S. 2394

S. 2394 would authorize an appropriation of $44.9 million to accomplish the purposes noted above. A breakdown of estimated costs, by category, appears below.

Estimated probable ceiling total cost of S. 2394	*Estimated cost in millions*
(1) Market value of 719 acres of land (with 843 improvements) to be acquired for transfer to Mexico and for relocation of the river channel and local public facilities	$24.4
(2) Relocation of 4.3 miles of the channel of the Rio Grande, the new channel to be concrete lined, and relocation of 6 existing bridges across the channel; the total cost is estmiated at $6.4 million, and by the treaty the United States will pay 50 percent, or	3.2
(3) Relocation of 6.8 miles of railroad tracks including market value of 19.6 acres of land	3.0

[1] Public Law 88–300, page 110, this Bulletin.

Estimated probable ceiling total cost of S. 2394—Continued

	Estimated cost in millions
(4) Relocation of public facilities:	
(*a*) As a part of the lands to be acquired there will be the city of El Paso's Navarro primary school and a part of the grounds of the Bowie High School, costs of which are included in the estimates of properties to be acquired; however, their relocation would require additional costs for land tentatively estimated at 11.1 acres	.6
(*b*) There will be acquired as a part of the lands a portion of the city's main sewage disposal plant, which will require replacement to permit equal utility of existing facilities, the increased cost of which is tentatively estimated at	.6
	1.2
Total	31.8
(5) Administrative costs, estimated at 4 percent	1.3
Estimated treaty cost under existing laws	33.1
(6) Compensation to avoid injury to property owners and tenants under sec. 3 of proposed legislation	4.2
(7) Estimated costs, relocation, and expansion port-of-entry facilities which are required in any event including market value of 20 acres	7.6
Estimated probable ceiling cost	44.9

IV. COMMITTEE ACTION

On December 12 and 13, 1963, the Committee on Foreign Relations held public hearings on the Convention on the Chamizal. During the course of those hearings, some of the testimony of administration and other witnesses related to the type of legislation that would be required to implement the convention and compensate the property owners and tenants who would be dispossessed as a result of the Chamizal settlement.

On January 21, 1964, the committee held a hearing on S. 2394. Appearing for the administration in support of the bill was Mr. Joseph F. Friedkin, U.S. Commissioner, International Boundary and Water Commission. United States and Mexico. In addition, Senator Ralph Yarborough of Texas and Representative Ed Foreman of Texas presented testimony. Senator John G. Tower of Texas submitted a statement for inclusion in the printed record of the hearing on the bill. The committee received telegrams from the Chamizal Civic Association, the Chamizal Committee, the El Paso Electric Co., and the mayor of El Paso, and a letter from Mr. W. W. McCallum, president, John Morrell & Co.. which also appear in the printed hearing.

The committee, after considering S. 2394 in executive session on January 28, without objection ordered the bill favorably reported to the Senate with amendments.

V. PROVISIONS OF S. 2394

Section 1. Investigations relating to new river channel; acquisition of required lands; relocation of facilities

Under the terms of the Convention on the Chamizal, the channel of the Rio Grande is to be relocated in the El Paso, Tex.-Ciudad Juárez, Chihuahua, sector and the centerline of the new channel is to be the international boundary.

Section 1(a) of S. 2394 would authorize the U.S. Commissioner, International Boundary and Water Commission, United States and Mexico, to conduct technical and other investigations relating to the demarcation or monumentation of the boundary; flood control; water resources; sanitation and prevention of pollution; channel relocation, improvement, and stabilization; and other matters related to the new river channel. These investigations would be conducted jointly with the Mexican section of the International Boundary and Water Commission.

Section 1(b) of the bill would authorize the U.S. Commissioner to acquire by donation, purchase, or condemnation, all lands necessary to implement the Convention on the Chamizal. The estimated market value of the 770 acres to be acquired is $29.7 million.

About a third of the area concerned consists of agricultural lands, stockyards, and vacant lands. In the other portions, however, are an estimated 843 improvements of various types, railroad trackage, utilities, and Government border inspection facilities. Among the improvements are family dwellings, shelters, and tenement buildings. In the list of 130 commercial concerns are 37 large properties, including a major meatpacking establishment, a customs and immigration inspection building leased from private owners, supply houses and warehouses, and chemical plants.

In the transfer of lands to Mexico 630.34 acres are involved: 366 acres to come from the Chamizal tract, 71.18 acres from an area under the jurisdiction of the United States and located just below Cordova Island (a Mexican enclave jutting into El Paso) and 193.16 acres of U.S. territory contiguous to the 71.18-acre tract. The United States will receive from Mexico 193.16 acres of Cordova Island. Moreover, it should be noted that, according to the terms of the agreement, a Mexican bank is to pay the United States $4,676,000 for the value of structures passing intact on the lands transferred to Mexico.

There will also have to be acquired 140 acres for rights-of-way for the portion of the new river channel and adjoining levee in the territory of the United States and for relocation of school properties, communication facilities, and public works in the area, including Federal port-of-entry inspection facilities.

Besides the cost of acquiring the land, certain relocations will have to be made at additional cost.

Relocation of the river pursuant to the convention will involve the construction of the new channel 4.3 miles in length, which will be concrete lined to minimize right-of-way requirements and provide an efficient waterway. New bridges to replace six existing bridges over the river will also involve relocation costs. The convention provides that costs of relocating the channel and the bridges (an estimated $6.4 million) will be shared equally between the United States and Mexico.

About 6.8 miles of railroad tracks situated in the area will have to be relocated at an estimated cost of $900,000. Reimbursement or replacement will have to be made for El Paso city properties consisting of a grammar school, part of the grounds of a high school, a portion of the lands of the city's main sewage plant, garbage disposal facilities, and utilities. Relocation of these city properties is expected to cost $1.2 million. Moreover, several Federal buildings and about 1.2 miles of a Federal irrigation canal will have to be replaced.

For relocation and expansion of port-of-entry facilities, a cost of $7.6 million is estimated.

Under section 1(c) of the bill, the U.S. Commissioner would be authorized to perform the work involved in connection with relocation of the railroads, the school properties, and construction of new Federal port-of-entry facilities; to enter into contracts with property owners for the acquisition of properties and performance of work; and to convey or exchange properties acquired or improved by the United States.

Section 2. Construction, operation, and maintenance of works

Under section 2 of the bill, the U.S. Commissioner would be authorized to construct, operate, and maintain all works provided for in the convention and the implementing legislation and, as deemed appropriate, to turn over the operation and maintenance of any such works to any Federal agency or any State, county, or other political subdivision. It is anticipated, for example, that the General Services Administration would operate and maintain properties acquired for Federal inspection facilities; that the Department of the Interior would operate and maintain the new relocated portion of a Federal irrigation canal; and that the lands and structures acquired for replacement of the El Paso school and other facilities, possibly including the U.S. portion of two new bridges, would become the responsibility of the city of El Paso.

Section 3. Compensation of owners and tenants to prevent economic injury

The Committee on Foreign Relations made a particularly careful examination of unique provisions in section 3 of S. 2394 relating to compensation of owners and tenants affected by the Chamizal settlement.

Payments under section 3 would be made pursuant to regulations approved by the Secretary of State, and subject to administrative determination by the U.S. Commissioner that the amounts involved were fair and reasonable.

In his statement before the committee, Commissioner Friedkin described the origin of section 3 as follows:

> Section 3 of the bill has its origin in the late President Kennedy's instructions to Ambassador Thomas C. Mann at the outset of the negotiations for the convention, that the people who live in El Paso today should not be injured by any settlement since they were not responsible for earlier failures to reach settlement. This section has been drawn with the view that this unprecedented circumstance of acquisition of private properties for transfer to another country warrants special consideration and treatment of the U.S. citizens affected.

Under subsection (a) of section 3, the owners and tenants affected by the Chamizal settlement may be reimbursed for moving expenses and related losses and damages. Such reimbursement shall in no event, however, exceed 25 percent of the fair value of the land. Application for payments under this subsection must be supported by an itemized and certified statement of the expenses, losses, and damages incurred. The section 3(a) authority parallels that granted by statute to the Department of the Army and the Department of the Interior.

Subsection (b) provides for compensation for certain categories of identifiable, reasonable, and satisfactorily proved costs and losses to owners and tenants over and above those related to moving expenses.

A Board of Examiners would be established to consider claims in these categories, and the Board would be empowered to hold hearings, to examine evidence, and to make determinations, subject to the Commissioner's approval. The Board would consist of men with experience in the fields of law, real estate, or business.

The categories referred to above are discussed below.

For nonconforming abodes and minimum forms of shelter for which there are no comparable properties on the market in the city of El Paso and concerning which compensation for fair market value would be inadequate to purchase minimum housing of equal utility, an owner may be compensated up to an amount which, when added to the market value allowed for his property, including land values, would enable purchase of minimum habitable housing of similar utility in another residential section of El Paso (sec. 3(b) (1) (a)).

Preliminary surveys show that for most of the single family dwelling units which would have to be vacated, there are comparable properties available on the market and that the fair market values offered will enable property owners to purchase like housing elsewhere in El Paso. However, there are about 90 shelters, substandard dwellings, for which there are no comparable properties on the market in El Paso and for which the market value would not be adequate to enable the purchase of minimum housing of like utility.

The committee has been informed that claims respecting this provision would be handled in the following manner: Upon receipt of a property owner's claim, the Government real estate officers would ascertain whether there were in fact no other comparable properties on the market. If not, they would determine the market value of the owner's property and that of the minimum housing of similar utility on the market, and these data would be presented to the Board of Examiners. The Board, upon finding the data fair and reasonable, would recommend to the Commissioner the added compensation required to enable the owner to reestablish himself in the minimum similar (standard) housing available to avoid economic loss or damage to the property owner.

Subsequent to the January 21 hearing on S. 2394, the administration reviewed its proposed basis for compensation in the case of commercial properties and proposed, as a substitute, the amended language of section 3(b) (1) (B) which the committee approved. This language should obviate the possibility of a commercial firm being able to better its present position at Government expense.

Thus, for commercial properties for which there are no comparable properties on the market in or near El Paso, the owner may be compensated up to an amount which, when added to the total fair market value, including the land value, would compensate him for the value in use of the real estate to him (sec. 3(b)(1)(B)). Such value in use is to be determined on the basis of replacement cost less deterioration and obsolescence in existing real estate and taking into consideration factors bearing upon income attributable to the real estate. The principal such factor is that of location.

Value in use would be determined by qualified appraisers who are specialists in the type of commercial properties to be acquired. They would first determine the cost of providing the minimum facilities of reasonably equivalent utility required to replace the existing properties. This would include surveys and investigations of the existing facilities, engineering and architectural studies, and estimates of necessary new replacement works. The appraisers would then determine and deduct from the replacement cost the actual reduction in value, if any, to the existing properties due to physical deterioration and to functional obsolescence. The deterioration would be ascertained by examination and survey. Functional obsolescence, defined as impairment in usefulness brought about by new inventions, current changes in design, and improved processes for production, would require careful survey and comparative analyses of existing properties with replacement properties.

Further, in this evaluation the appraisers would obtain and take into consideration as a measure of obsolescence, reductions in costs of production, if any, with the new properties compared to the old. Moreover, in their overall appraisal of the value in use to the owner, appraisers would take into consideration the net income of the owner, and its equivalent capital value to him. The resulting appraisals and supporting data would be reviewed for fairness and equity by the Board of Examiners provided for in the proposed legislation, and their recommendations transmitted to the Commissioner for consideration in the final determination.

Under section 3(b)(2)(a), provision is made for compensation for loss of profits directly resulting from relocation of a business. Such compensation is restricted to the period between termination of business in the old location and commencement of business in the new, but such period may not exceed 30 days.

Questions were raised in the committee about the adequacy of the 30-day time limitation. After reviewing this matter, the administration informed the committee of its continued belief that 30 days was an adequate period in which to permit relocation of each business, and that any increase might result in some property owners unnecessarily drawing out the time required for moving, with increased costs to the Government. It was noted that prior to moving, and prior to terminating business at the old site, the owner's new site should be ready for commercial operations to begin, and that regulations covering the acquisition of an original property would allow reasonable time for preparation of a new site. With this explanation, the committee was satisfied that the 30-day time period is sufficient.

Under section 3(b)(2)(b), compensation may be paid for a loss to an owner resulting from his inability to rent to others housing or commercial space when such inability can be reasonably related to uncertainties arising out of the pending acquisition of the owner's property by the United States. Such losses are limited to those incurred after July 18, 1963, the date Presidents López Mateos and Kennedy publicly announced approval of the proposed terms of settlement of the Chamizal dispute, and prior to the making by the United States of a firm offer to purchase. The original restriction in the bill dealing with warehouse space was broadened to take into account commercial space that an owner may have been unable to rent in the circumstances described above.

Under section 3(b)(3), compensation may be provided for penalty costs to property owners for prepayment of mortgages incident to acquisition of properties by the United States.

Under a ceiling limitation of $4.2 million which may be paid as compensation under section 3, an estimated breakdown follows below:

Probable ceiling estimate—Compensation under sec. 3, S. 2394

Moving expenses	$770,000
No comparable properties	2,655,000
Loss in profits, commercial and industrial	450,000
Loss to owners due to inability to rent	315,000
Penalty for prepayment of mortgages	10,000
Total	4,200,000

Section 4. Time limit on application for reimbursement or compensation

Application for reimbursement or compensation under section 3 of the bill must be submitted to the Commissioner within either 1 year from the date of acquisition or the date of vacating the premises by the applicant, whichever date is later (sec. 4).

Section 5. Limitation on attorneys' fees

During the hearing on S. 2394, concern was expressed that attorneys' fees for claims submitted under section 3 might prove to be excessive. Section 5 of S. 2394 would allow the Commissioner discretionary authority to limit such fees to a maximum of 10 percent of the award. Such an amount would be paid out of, but not in addition to, the amount of the award. Any attorney who charges, demands, receives, or collects for services rendered in connection with such claim any amount in excess of the allowable amount shall be fined not more than $2,000 or imprisoned not more than 1 year, or both. Besides protecting the claimant from exorbitant legal fees in connection with claims under section 3, this provision may also protect an attorney's fee by insuring him payment for services.

Section 6. Prohibition against duplicate payments

Section 6 would serve to prohibit duplicate payments and would provide that the exercise of the right of eminent domain and other rights of the Government would not be precluded, nor would the rights of owners and tenants under other laws or the U.S. Constitution be affected by this bill.

Section 7. Exclusions from gross income

Section 7 provides that the amounts of awards under subsection (a) (moving expenses) and subsections (b)(1) (noncomparable properties) and (b)(3) (prepayment of mortgages) of section 3 of the bill shall not be included in gross income for purposes of chapter 1 of the Internal Revenue Code of 1954. An exception is made, however, where amounts received under subsection (b)(1) are not used within 1 year of the receipt thereof to purchase replacement housing or facilities. To the extent not so used, the amounts shall be included in gross income.

Section 8. Definitions, exemption from operations of Administrative Procedure Act

The term "land" is defined to include interests in land, the term "fair value" to mean fair value of the interest acquired.

Inasmuch as the bill establishes a compensation procedure, provisions of the proposed act would be exempt from the operations of the Administrative Procedure Act of June 11, 1946 (60 Stat. 237), as amended (5 U.S.C. 1001–1011).

Section 9. Authorization of appropriations

Section 9 of S. 2394 authorizes the appropriation to the Department of State of not to exceed $44.9 million to carry out the provisions of the Convention on the Chamizal and this proposed act. The appropriation authorized would be for the use of the U.S. section of the International Boundary and Water Commission, United States and Mexico.

A ceiling of $4.2 million is set on the amount of the total appropriations authorized which may be expended to carry out section 3 of the proposed act.

Section 9 also makes applicable to the carrying out of the provisions of the convention and the proposed act, the provisions of section 103 of the American-Mexican Treaty Act of 1950 (22 U.S.C. 277d–3). This would enable the Com-

mission to discharge efficiently its responsibilities by having authority to use the appropriated sums for such housekeeping items as personal services, rent, transportation, communications, and supplies.

VI. COMPLIMENTARY PROJECTS

During the hearings on the Convention on the Chamizal and on S. 2394, the committee's attention was called to the interest of citizens of El Paso in several improvement projects which might be possible of realization with the satisfactory resolution of the Chamizal dispute. These proposed projects relate to the establishment of a U.S. National Park on lands to be transferred to the United States pursuant to the convention, the construction of a border highway along the new location of the Rio Grande, and relocation and improvement of a Federal irrigation canal in the El Paso area.

The committee has been informed that appropriate agencies of the executive branch have these projects under consideration and are making studies of their feasibility. The committee weighed a suggestion that these projects be made part of S. 2394 and concluded that it would be best to proceed with the bill in its present form in order that the owners and tenants affected by the Chamizal settlement might be relieved of their uncertainties and relocated as soon as possible.

In the event that in the future projects for the park, the border highway, and the canal are presented to the Congress, the committee hopes they will receive prompt attention and consideration.

VII. CONCLUSIONS AND RECOMMENDATIONS

More than half the funds authorized to be appropriated in S. 2394 will be spent for the necessary acquisition of lands and properties thereon and for compensating property owners and tenants.

The committee realizes that settlement of the long standing boundary dispute with Mexico over the Chamizal will create difficult readjustment problems for the some 4,500 people and the commercial firms which will have to leave their established residences and places of business and relocate elsewhere. The committee has been assured by the executive branch that the unusual compensation provisions in section 3 of S. 2394 are designed to authorize compensation to keep the property owners and tenants whole—but no more—and to assure that no bonuses or enrichments will accrue to the occupants removed from their lands or properties. That approach seems to the committee fair and sound, and there appear to exist sufficient safeguards to insure the carrying out of that approach.

The estimated costs of relocating the river channel, bridges, railroad tracks, and public facilities, and of relocating and expanding port-of-entry facilities, seem reasonable.

In the committee's opinion, S. 2394, as amended, merits the approval of the Senate, and favorable action at an early date is recommended on the bill.

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